83-614

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, et al.,

Respondents.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 83-4019

Argued: May 23, 1983

Decided: July 15, 1983
(as amended September 20, 1983)

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—against—

BOARD OF GOVERNORS OF THE FEDERAL
RESERVE SYSTEM, et al.,

Respondents,

—and—

BANKAMERICA CORPORATION,

Intervenor.

Appearances

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Before:

FEINBERG, *Chief Judge*,
LUMBARD and WINTER, *Circuit Judges*.

LUMBARD, *Circuit Judge*:

On January 7, 1983 the Federal Reserve Board authorized the BankAmerica Corporation, a bank holding company, to acquire the Charles Schwab Corporation, the sole owner of Charles Schwab & Co., the nation's largest "discount" brokerage firm. The Securities Industry Association (SIA), a national trade association representing over 540 securities brokers,

dealers, and investment banking companies, petitions for judicial review of the Board's order. SIA contends that the acquisition approved by the Board violates both the Glass-Steagall Act and the Bank Holding Company Act. We find, however, that neither of those Acts prohibits a bank holding company from engaging in retail brokerage, and that the Board acted well within its discretion in approving BankAmerica's application. We therefore deny SIA's petition for review and affirm the order of the Board.

The BankAmerica Corporation (BAC), with total assets of $120.5 billion, is the second largest bank holding company in the United States. BAC's most important subsidiary is the Bank of America (Bank) which, with domestic deposits of $52 billion, is the nation's largest commercial bank. Charles Schwab & Co. (Schwab) is principally engaged in retail securities brokerage. Schwab buys and sells securities solely as agent, on the order and for the account of its customers. Schwab offers its brokerage customers incidental services including margin loans, securities custodial services, and "sweep" accounts in which net balances awaiting investment are deposited in a money market fund not affiliated with Schwab. Schwab does not, however, offer its customers investment advice and, with minor exceptions not here relevant, does not underwrite or deal in securities. Schwab and similar firms are called "discount brokers" because the commissions they charge typically are significantly lower than those charged by full-service brokerage firms which offer investment advice. Schwab, headquartered in San Francisco, operates nationwide with offices in 26 states and the District of Columbia. Although, by revenue, Schwab currently holds 9% of the discount brokerage market, it holds less than 1% of the total retail brokerage market.

On March 8, 1982 BAC applied to the Federal Reserve Board for permission to acquire 100% of the stock of Schwab's parent corporation. BAC filed its application under § 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8) (1976), which authorizes the Board to approve a bank holding company's acquisition of a subsidiary if the subsidiary's activities are "closely related" to banking and if

the public benefits reasonably to be expected from the acquisition outweigh possible adverse effects. The Board published notice of BAC's application in the Federal Register, 47 Fed. Reg. 16,104 (1982), and requested comments from interested parties. The Antitrust Division of the Department of Justice, the Comptroller of the Currency, and the Securities and Exchange Commission all filed comments in support of the application. SIA opposed the application and requested the Board to conduct a formal hearing. An administrative law judge held an evidentiary hearing in September, 1982, and on November 12, 1982, issued his decision recommending that the acquisition be approved. The judge found the proposed acquisition to be consistent with both the Glass-Steagall Act and the Bank Holding Company Act. On January 7, 1983 the Board adopted the judge's findings and conclusions, with modifications, and authorized BAC to acquire Schwab. 69 Fed. Res. Bull. 105 (1983). SIA petitions for review under 12 U.S.C. § 1848 (1976).

I. *Glass-Steagall Act*

Those provisions of the Banking Act of 1933 that mandated a separation of the commercial and investment banking industries are known as the Glass-Steagall Act. *See* Pub. L. No. 73-66, §§ 16, 20, 21, & 32, 48 Stat. 162 (1933). SIA claims that the Glass-Steagall Act prohibits bank holding company subsidiaries from conducting a retail brokerage business. Although SIA's claim raises an issue of law which we have the ultimate responsibility to decide, *see* 5 U.S.C. § 706 (1976), the Board's thorough opinion rejecting the claim is entitled to substantial deference. Because the Board has both primary responsibility for implementing the Glass-Steagall Act and expert knowledge of commercial banking, we must uphold its interpretation of the Act if it is reasonable. *See Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 56 n.21 (1981), quoting *Board of Governors* v. *Agnew*, 329 U.S. 441, 450 (1947) (Rutledge, *J.*, concurring); *Investment Co. Inst.* v. *Camp*, 401 U.S. 617, 626-27 (1971); *A.G. Becker Inc.* v. *Board of Governors*, 693

F.2d 136, 140-41 (D.C. Cir. 1982). We conclude that the Board's interpretation was reasonable and entirely consistent with the Act's language and policy.

Only one of the Glass-Steagall Act's four provisions is directly applicable to bank holding companies. That provision, § 20, 12 U.S.C. § 377 (1976) states:

> [N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization *engaged principally in the issue, flotation, underwriting, public sale, or distribution* at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . .

(emphasis supplied). As a bank holding company's various subsidiaries are bank affiliates for purposes of § 20, *see* 12 U.S.C. § 221a(b) (1976), BAC's acquisition of Schwab will make Schwab an affiliate of Bank. Section 20 therefore prohibits the acquisition if Schwab is "engaged principally" in any of the activities listed in the statute. Although SIA concedes that Schwab is not engaged in the issue, flotation, underwriting, or distribution of securities, it argues that Schwab's retail brokerage business does constitute the "public sale" of securities.

SIA's interpretation of "public sale" to include brokerage is rebutted by the "familiar principle of statutory construction that words grouped in a list should be given related meaning." *Third Natl. Bank in Nashville* v. *Impac, Ltd.*, 432 U.S. 312, 322 (1977) (footnote omitted). *See also General Elec. Co.* v. *OSHA*, 583 F.2d 61, 65 (2d Cir. 1978). The terms "issue," "flotation," "underwriting," and "distribution" all refer to the widespread marketing of specific issues of new securities in which the dealer trades as principal for his own profit. *See generally* L. Loss, Securities Regulation 159-72 & 547-53 (2d ed. 1961). Such activities greatly differ from retail brokerage, in which the broker trades as an agent for commission, not as a principal for profit, and does not transfer title. Thus if "public sale" is to be given a meaning similar to that of the terms that surround it, it cannot be read to encompass retail brokerage.

Moreover, if Congress had intended § 20 to cover brokerage, it presumably would have used words more precise than "public sale." Section 16 of the Act, 12 U.S.C. § 24(7) (1976), authorizes banks to engage in "purchasing and selling . . . securities and stocks without recourse, solely upon the order, and for the account of, customers." Congress' use in § 16 of language that specifically refers to brokerage,[1] and its omission of similar terms from § 20, suggests that Congress did not intend § 20 to cover brokerage. *See FTC* v. *Sun Oil Co.*, 371 U.S. 505, 514-15 (1963) (terms carefully employed by Congress in one place, and excluded in another, should not be implied where excluded).

The Board's ruling that § 20 does not encompass brokerage is supported by its long-standing interpretation of a different provision of the Glass-Steagall Act, § 32, 12 U.S.C. § 78 (1976). Section 32 prohibits managerial or other interlocks between member banks and any entity primarily engaged in "the issue, flotation, underwriting, public sale, or distribution" of securities. Section 32's list of prohibited activities is precisely that found in § 20. In January, 1936, shortly after the Banking Act of 1935 revised § 32 into its present form, the Board ruled that "[a] broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32." 22 Fed. Res. Bull. 51 (1936). The Board's interpretation of § 32, to which it still adheres, *see* 12 C.F.R. § 218.1 n.1, has been confirmed by the Supreme Court. In *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947), two directors of a national bank also worked for a securities firm which derived approximately 32% of its gross income from underwriting, and 42% from brokerage. The Board ruled that the directors' outside firm was "primarily engaged" in activities covered by § 32, and it ordered the directors to resign from the bank. The directors challenged the Board's order in court. The District of Columbia Court of Appeals, by a divided vote, held that an injunction should issue. 153 F.2d 785 (1946). The

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1 The scope of the brokerage activities which § 16 authorizes banks to conduct is open to debate. *See infra*.

majority and dissenting opinions in the Court of Appeals agreed that § 32 does not cover brokerage. 153 F.2d at 790, 795. They disagreed only on the degree of involvement necessary for a firm to be "primarily" engaged in an activity prohibited by § 32. The Supreme Court granted certiorari and reversed. The Court concluded, as had the dissenting judge in the Court of Appeals, that a firm is "primarily" engaged in a prohibited activity if it is "substantially" so engaged, and that the Board's order was therefore lawful notwithstanding the fact that the directors' outside firm earned less than half of its revenue from underwriting. Although the Court did not explicitly rule brokerage to be excluded from § 32, it did distinguish the firm's brokerage income from its underwriting income, and used the language of § 32 to define "underwriting" as the "issue, flotation, underwriting, public sale or distribution" of securities. 329 U.S. at 445 n.3. It thus seems clear that the Court read § 32 to exclude brokerage. Indeed, if the Court had not so read the statute, it would not have had to explore the meaning of "primarily engaged," since the directors' outside employer was, under any interpretation of the term, "primarily engaged" in underwriting and brokerage taken together. Use of the same language in different statutory provisions, where the various provisions were enacted together and concern the same general goals, is a strong indication that Congress intended the language to have the same meaning wherever it appears. *See Northcross* v. *Board of Educ. of the Memphis City Schools*, 412 U.S. 427, 428 (1973); *Hargrave* v. *Oki Nursery, Inc.*, 646 F.2d 716, 720 (2d Cir. 1981). The Board's consistent interpretation excluding brokerage from § 32 is thus, especially in view of *Agnew*, strong evidence that brokerage is excluded from § 20.[2]

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2 Also significant is the Supreme Court's comment in *Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 58 n.24 (1981), that § 20 prohibits bank ownership of securities affiliates that are engaged principally "in the issuance or underwriting of securities." The Court's failure to include "brokerage" in the list of activities covered by § 20 is a further suggestion that brokerage is excluded from the statute.

The policies behind the Glass-Steagall Act shed further light on the proper interpretation of § 20. Congress intended the Act to address two principal concerns. First and foremost, Congress believed that commercial bank involvement in underwriting and securities speculation had unduly placed bank assets at risk and had contributed to "the widespread bank closings that occurred during the Great Depression." *Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 61 (1981) (footnote omitted). Securities trading had impaired bank solvency not only directly through bad investments by banks, but also indirectly through the unsound banking practices that securities trading promoted. In particular, Congress recognized that a bank trading for its own account has a "salesman's interest" that is inconsistent with the traditional role of banks as impartial extenders of credit. A bank seeking to sell the stock of a particular company might, for example, extend customers credit to be used for purchase of the stock or might grant the company an unsound loan simply to improve the stock's marketability. *See Investment Co. Inst.* v. *Camp*, 401 U.S. 617, 631 (1971). Similarly, a bank that engages in trading through a securities affiliate might improperly extend credit to the affiliate, or to companies in which the affiliate invested, in order to avoid the loss in public confidence it would experience if the affiliate failed. Securities trading further shakes public confidence in banks because it associates banks with speculative ventures, and because some customers purchasing securities on bank representations will inevitably suffer losses. This loss of public confidence poses an additional threat to bank solvency. *See id.*, 401 U.S. at 631-32. Thus in strictly limiting the right of commercial banks to trade in securities, Congress sought to ensure bank solvency, to protect bank depositors, and to maintain public confidence in the nation's banks. Second, Congress recognized the inherent conflict between the promotional role of an investment banker and the commercial banker's obligation to give disinterested investment advice. A commercial bank that trades as a principal might allow its interest in trading profits to override the fiduciary duties owed to depositors. *See id.*, 401 U.S. at 633. Congress thus intended

the Glass-Steagall Act to guarantee that the impartiality of investment advice would not be "tainted by a desire to profit from the promotion of one particular security over another." Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 Yale L.J. 102, 104 (1981) (footnote omitted).

Schwab's brokerage services do not present any of the dangers which the Glass-Steagall Act was designed to forestall. Because Schwab trades only as an agent, and never as a principal, its assets are not subject to the risks of the securities markets. Equally important, Schwab's lack of a "salesman's interest" in the securities it trades eliminates the incentive for the Bank to engage in promotional activities. Schwab's revenue depends solely on the volume of shares traded, and is not dependent upon the sale or purchase of specific securities. Thus the Bank cannot increase Schwab's profits by extending credit to securities issuers to bolster their stock or to purchasers for the purchase of specific shares, or by improperly favoring particular securities in its management of customers' assets. Although Schwab and the Bank will be associated with one another in the public eye, the losses that some customers will sustain on trades executed through Schwab will be unlikely to impair public confidence in the Bank. Given Schwab's strict policy not to offer investment advice, customers who trade unsuccessfully will have only themselves, and not Schwab or the Bank, to blame for their mistakes.

The Act's legislative history and Supreme Court precedent support our interpretation of the Act's focus. First, the legislative history, though it discusses at length the dangers posed by commercial bank involvement in underwriting and securities speculation, *see*, *e.g.*, S. Rep. No. 77, 73d Cong., 1st Sess. 8-10 (1933), makes but passing reference to bank brokerage activity. The Senate report states only that the Act allows banks to "purchase and sell investment securities for their customers to the same extent as heretofore." *Id.* at 16. This statement hardly suggests that brokerage was one of Congress' principal concerns. Second, in *Investment Co. Inst.* v. *Camp*, *supra*, the Supreme Court drew a clear distinction between brokerage and activities in which a bank trades as a principal. In *Camp*, the

Court held that a bank's plan to distribute shares in a bank-managed open-end investment fund would constitute an impermissible underwriting of securities in violation of § 16 of the Act. The Court emphasized that the bank would have a salesman's stake in the fund's shares, and thus would have an incentive to engage in promotional activities contrary to the Act's policy. The Court contrasted the bank's plan with brokerage services, and stated that the hazards associated with promotional activities "are not present when a bank undertakes to purchase stock for the account of its individual customers." 401 U.S. at 638. The Court stated that purchases on account "do not give rise to a promotional or salesman's stake in a particular investment; . . . do not entail a threat to public confidence in the bank itself; . . . and do not impair the bank's ability to give disinterested service as a fiduciary or managing agency." *Id.* The Court's comments, though dicta, strongly suggest that Congress did not intend § 20 to prohibit bank affiliates from engaging in retail brokerage. *See also New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091, 1099-1100 (D.D.C. 1975) (bank's plan to purchase securities on account for customers, and automatically to deduct designated purchase amount from customers' bank accounts, held to be consistent with the Act), *vacated on other grounds*, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

We thus find the Board's ruling to be supported by both the language of § 20 and the Act's policy. SIA argues, however, that § 20's true meaning cannot be found without reference to § 16 of the Act, 12 U.S.C. § 24(7) (1976), which defines the extent to which commercial banks may trade in securities. Section 16 states, in pertinent part, that:

> The business of dealing in securities and stock by [a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account.

Although SIA concedes, as indeed it must, that § 16 is directly applicable only to banks, and not to bank holding companies, *see Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46,

58 n.24 (1981), it argues that §§ 16 and 20 must be interpreted "consistently," and cannot be read to permit bank holding companies a broader degree of brokerage activity than is allowed to banks. SIA contends that § 16 does not authorize banks to conduct retail brokerage businesses such as Schwab's. SIA's position is supported by certain early rulings by the Comptroller of the Currency which held that § 16 authorizes a bank to engage in brokerage only if (1) the customer has a customer relationship with the bank independent of the brokerage transaction, (2) the bank offers its brokerage services at cost, and (3) the customer makes prior payment or has assets at the bank sufficient to cover his transaction. *See e.g.*, 1 Bulletin of the Comptroller of the Currency, No. 2 at 2-3 (1936). Relying principally upon the Comptroller's rulings, SIA argues that banks may engage in brokerage only to accommodate existing customers, and that the principal brokerage activities of bank holding companies must, under a consistent interpretation of the Act, be similarly limited.

The proper interpretation of § 16 is before us only incidentally, and we do not think it necessary to explore the question in detail. Instead, three considerations convince us that SIA's attempt to transfer the focus of this case from § 20 to § 16 is unavailing. First, the Comptroller of the Currency recently reversed the rulings upon which SIA relies. In *Security Pacific Natl. Bank*, [Current] Fed. Bank. L. Rep. ¶ 99,284 (CCH) (1982), the Comptroller held that § 16 authorized a national bank to establish a subsidiary that would offer discount brokerage services to the public but would not offer investment advice. The Comptroller stated that his earlier restrictive rulings reflected "the great caution of banking regulations in the years immediately following the 1931-32 debacle," and were not supported by either the purposes or the express language of the Glass-Steagall Act. Because we agree with the Comptroller that the Act's policies are not contravened by bank participation in retail brokerage, we are inclined to give significant weight to the Comptroller's repudiation of his earlier rulings.[3]

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3 SIA has brought an action in the District Court for the District of Columbia challenging the Comptroller's ruling in *Security Pacific*

Second, SIA has not convincingly explained why §§ 16 and 20, notwithstanding Congress' use of very different language in the two provisions, must be interpreted alike. If, as SIA contends, Congress intended in §§ 16 and 20 significantly and equivalently to restrict the brokerage activities of banks and bank holding companies, it presumably would have used the same, or at least similar, language in both statutes. Finally, the structure of the Act "reveals a congressional intent to treat banks separately from their affiliates," *Investment Co. Inst.*, *supra*, 450 U.S. at 59 n.24, and clearly indicates that the same prohibitions do not apply to both. Banks, for example, under § 16 can never underwrite or deal in the securities of private issuers, while bank holding companies, under § 20, can engage in such underwriting and dealing so long as they are not principally so engaged. SIA argues that this distinction between §§ 16 and 20 is unimportant; that the same *types* of activities are prohibited to banks and to bank holding companies; and that bank holding companies, even if they can partially engage in certain activities totally barred to banks, cannot principally engage in such activities. SIA thus concludes that § 20 at most authorizes Schwab minimally to engage in retail brokerage, and does not allow it to make brokerage a principal line of business. We think, however, that the latitude the Act grants bank holding companies partially to engage in activities such as underwriting, which implicate the Act's policies whether conducted by banks or by bank holding companies, suggests that bank holding companies can, under the Act, be allowed principally to engage in activities which pose the dangers the Act addressed only when conducted by banks. Congress clearly intended the Act to restore banking as the principal business of banks, and may have believed (though we see no support for the point in the legislative history) that banks would be unreasonably diverted from banking by participation in retail brokerage. But even if Congress, because of

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Natl. Bank. Securities Industry Assoc. v. *Conover*, No. 82-2865 (D.D.C. filed October 6, 1982). What we say here is not meant to express an opinion on the validity of the Comptroller's ruling.

such concerns, restricted in § 16 the brokerage activities allowed to banks, no similar danger of diversion is posed by the brokerage activities of bank holding companies. Thus even if § 16 prohibits banks from acting as retail brokers, we would have to conclude, in light of (1) the statutory language and policy considerations previously discussed and (2) the Act's clear intent to "treat banks separately from their affiliates," that Congress did not intend § 20 to prohibit bank holding companies from acquiring or establishing brokerage subsidiaries.[4]

II. *Bank Holding Company Act*

The Bank Holding Company Act, 12 U.S.C. §§ 1841 *et seq.* (1976), generally prohibits bank holding companies from engaging in nonbank activities. However, section 4(c)(8) of the Act, 12 U.S.C. § 1843(c)(8), provides that a bank holding company may acquire:

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4 SIA also argues that the Board's order contravenes the provision of § 16 that limits national banks to "purchasing and selling such securities and stock without recourse. . . ." SIA contends that Schwab trades "with recourse" because brokerage customers occasionally "walk away" from trades that prove unprofitable within the settlement period, leaving Schwab liable to the third party to the transaction for the purchase price or for delivery of the security. Beyond the fact that SIA has not convinced us to incorporate § 16's language into § 20, we do not think that Schwab's activities violate § 16 merely because it faces the kind of incidental liability to which SIA refers. The Supreme Court's decision in *Awotin* v. *Atlas Exchange Natl. Bank of Chicago*, 295 U.S. 209, 212 (1935) (holding that a repurchase agreement between the bank and one who bought bonds from it was void as a violation of § 16), strongly suggests that the limitation in § 16 is directed against endorsement or guaranty contracts "by which the bank assumes the risk of loss which would otherwise fall on the buyer of securities, or undertakes to insure to the seller the benefit of an increase in value of securities which would otherwise accrue to the Bank." Schwab does not enter into contracts that obligate it to "assume" ultimately its brokerage customers' risks; on the contrary, it retains full power to bring actions for breach of contract against customers who fail to pay for or deliver securities.

> shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Section 4(c)(8) further provides that:

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern.

Section 4(c)(8) authorizes the Board to approve a bank holding company's acquisition of a nonbank subsidiary only if it determines that (1) the subsidiary's activities are "closely related" to banking, and (2) the public benefits reasonably to be expected from the acquisition will outweigh possible adverse effects. *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess. (1970) *reprinted in* 1970 U.S. Code Cong. & Ad. News 5561, 5572-73. *See, e.g., Independent Ins. Agents of America, Inc.* v. *Board of Governors*, 658 F.2d 571, 573 (8th Cir. 1981); *Citicorp* v. *Board of Governors*, 589 F.2d 1182, 1190 (2d Cir.), *cert. denied*, 442 U.S. 929 (1979); *National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1232-33 & n.2 (D.C. Cir. 1975). SIA challenges the Board's ruling that BAC's acquisition of Schwab satisfies both of these requirements.

Section 4(c)(8) and its legislative history do not identify the factors the Board is to consider in determining which activities are closely related to banking. However, in *National Courier*

Assn., *supra*, 516 F.2d at 1237, the District of Columbia Court of Appeals held that the Board may treat any activity as one closely related to banking if there is present one or more of the following connections between the activity and the business of banking:

> 1. Banks generally have in fact provided the proposed services.
>
> 2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.
>
> 3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

Although the factors listed in *National Courier Assn.* do not exhaust the possible connections which could establish a close relationship between a proposed activity and banking, *see id.*, they do usefully elucidate the closely related standard and have been employed by several of the courts of appeals, *see NCNB Corp.* v. *Board of Governors*, 599 F.2d 609, 613 (4th Cir. 1979); *Association of Bank Travel Bureaus, Inc.* v. *Board of Governors*, 568 F.2d 549 (7th Cir. 1978); *Alabama Assn. of Ins. Agents* v. *Board of Governors*, 533 F.2d 224, 241 (5th Cir. 1976), and by the Board. *See, e.g.*, *Citicorp*, 68 Fed. Res. Bull. 505 (1982).

In this case the Board, relying upon the second of the *National Courier Assn.* factors, held that the present securities activities of banks are operationally or functionally so similar to brokerage that banks are particularly well equipped to act as retail brokers. The Board found that many banks, as an accommodation to their customers, transmit to brokers customer orders to buy or sell securities, and that the trading desks of bank trust departments routinely buy and sell securities as agents for trusts and other accounts. The Board noted one principal difference between the securities activities of brokerage houses and of banks: brokerage houses trade listed

securities directly on the exchanges, while banks historically have employed intervening brokers to execute such trades, but it concluded that banks nonetheless have expertise in the methods of securities trading. The Board found that banks, when trading unlisted securities, often deal directly with dealers or other third parties, and that such trades require banks to "exercise the same type of discretion and judgment with respect to the best method of execution that brokers do with respect to similar types of orders." The Board further found that when banks employ intervening brokers, they often direct the broker on the best method of execution, and leave to the broker only the technical execution of the transactions. Finding that banks widely buy and sell securities for the accounts of their customers, and have become skilled in securities trading, the Board held that retail brokerage is an activity closely related to banking.

The Board's factual findings are conclusive if supported by substantial evidence, 12 U.S.C. § 1848, and the Board's findings on bank trading activities are clearly so supported. SIA, however, argues that the Board misapprehended the legal standard implicit in the closely related test. SIA claims that an activity is closely related to banking only if it facilitates actual banking practices[5] and can be conducted by most of the

5 As enacted in 1956, § 4(c)(8) (then § 4(c)(6)) authorized bank holding companies to engage in activities "of a financial, fiduciary, or insurance nature . . . which the Board . . . has determined to be so closely related to *the business of banking* . . . as to be a proper incident thereto." Pub. L. No. 511, § 4(c)(6), 70 Stat. 137 (1956). The Board interpreted the phrase, "the business of banking," to prohibit bank affiliation with any company whose activities were not directly related to the banking operations that the particular holding company was already engaged in. Congress in 1970 deleted the words "the business of" in order to make it clear that the acquired company's activities need not be closely related to the acquiring holding corporation's specific banking business, but only to banking generally. *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 5561, 5567; *National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1236 (D.C. Cir. 1975). SIA thus argues that § 4(c)(8) required the Board to find that retail brokerage facilitates banking generally, and does not argue that facilitation of BAC's particular banking operations is required.

nation's banks. SIA argues that brokerage does not satisfy either of those requirements, and is therefore not closely related to banking. We do not agree.

SIA's challenge to the Board's legal conclusion must be evaluated in light of the deference ordinarily due to Board determinations under § 4(c)(8). Congress has committed to the Board primary responsibility for the administration of the Act. The Board, moreover, has expertise in commercial bank regulation that the courts do not have, and it must be allowed reasonable latitude in its application of the Act to the changing activities of banks. For these reasons the Board's determination that brokerage is closely related to banking "is entitled to the greatest deference," *Investment Co. Inst.*, *supra*, 450 U.S. at 56 (footnote omitted), and may be overturned only if unreasonable or inconsistent with Congressional intent. *See National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1237 (D.C. Cir. 1975). We see nothing in SIA's arguments that would justify reversal of the Board's order under this standard of review.

SIA's claim that an activity must facilitate actual banking practices to be closely related to banking is, we think, refuted by the Supreme Court's decision in *Investment Co. Inst.*, *supra*. In *Investment Co. Inst.*, the Supreme Court upheld a Board regulation issued under § 4(c)(8) that authorized bank holding company subsidiaries to serve as investment advisers to closed-end investment companies. An investment company offers small investors portfolio diversification and expert management by pooling their resources under the guidance of one manager. Investment advisers are independent of the investment companies they advise. In return for a management fee, an investment adviser selects the investment company's portfolio and supervises most aspects of its business. In affirming the Board's determination that investment advisory services are closely related to banking, the Court emphasized that such services "are not significantly different from the traditional fiduciary functions of banks." 450 U.S. at 55. The Court stated that the principal duty of an investment adviser is to manage the investment portfolio of its client, and noted that

banks, in their roles as executors, trustees, and managing agents, have for decades provided equivalent management services to bank customers. *Id.* The Court's analysis thus focused upon the relationship of investment advisory services to services traditionally performed by banks. The Court upheld the Board's regulation because the proposed activity constituted, in effect, the provision in a nonbanking context of services that banks have traditionally offered their customers. The Court never considered whether investment advisory services provided to nonbank investment companies facilitate actual banking practices, and it seems quite clear that they do not. Thus both the result reached in *Investment Co. Inst.*, and the analysis the Court employed, indicate that an activity need not facilitate banking practices to be closely related to banking.

SIA also contends that an activity, to be closely related to banking, must be open to most banks. SIA argues that only the largest banks have the skills and resources needed to engage in retail brokerage; that banks *generally* will not be able to enter the brokerage business; and that brokerage is therefore not closely related to banking. SIA's argument ignores the Board's express finding "that the use of sophisticated techniques, resources and personnel to execute orders for the purchase or sale of securities for the account of customers is sufficiently widespread in the banking industry to justify a finding that banks generally provide securities execution services that equip them to offer the type of retail brokerage services provided by Schwab." In any event, even if the Board had found to the contrary, we could not accept SIA's conclusion. The closely related standard does not require proof that banks generally will be able to perform the proposed service, but instead principally concerns whether the proposed service is functionally related to the traditional services banks generally have performed. The interpretation SIA gives the Act would effectively preclude the nonbank affiliates of bank holding companies from providing financial services not open to the smallest banks. We see nothing in the legislative history to suggest that Congress intended the closely related standard so greatly to

restrict innovation in the financial industry. *Cf.* H.R. Conf. Rep. No. 1747, *supra*, 1970 U.S. Code Cong. & Ad. News at 5568 ("One of the asserted justifications for permitting bank holding companies to engage in activities that the Board has determined independently to be closely related to banking, is to permit the introduction of new innovative and competitive vigor into those markets which could benefit therefrom."). An inability of banks generally to engage in a proposed activity may, of course, raise questions of competitive effect or undue concentration of resources, but such questions are appropriately resolved under § 4(c)(8)'s public benefits test and not under the closely related standard.

Finally, SIA challenges the Board's determination that the public benefits reasonably to be expected from BAC's acquisition of Schwab will outweigh the possible adverse effects. We see no basis for disturbing the Board's conclusion. As the Fifth Circuit has recognized, *see Alabama Assn. of Ins. Agents*, *supra*, 533 F.2d at 246, Board determinations under the public benefits test necessarily involve some speculation, and should be upheld if reasonable. The Board's ruling here plainly is reasonable.[6] SIA further argues that the Board erred in failing

6 The Board found that a number of public benefits are likely to result from BAC's acquisition of Schwab. The Board found that the acquisition will strengthen Schwab as a competitor by affording it access to BAC's managerial, financial, and technical resources. Noting that Schwab competes primarily on the basis of price, the Board stated that the strengthening of Schwab could induce full-line brokers to engage in greater price competition. The Board found that Schwab's affiliation with BAC, a large, internationally-known financial services company, should increase public confidence in Schwab and in discount brokers generally. Because discount brokers have been hampered by a lack of public awareness and acceptance of their services, increased public confidence in discount brokers should enhance their ability to compete against better-known firms. Finally, the Board found that Schwab's affiliation with BAC will increase consumer convenience. For example, Schwab offices operated at branches of the Bank will reduce consumer search costs by enabling consumers to obtain a broader range of financial services at a single location than is now possible. The Board found that the acquisition is unlikely to have any significant adverse effects, such as undue concentration of resources, decreased competition, or unfair competitive practices.

to require de novo entry by BAC into the retail brokerage business. Section 4(c)(8) states that in orders under the statute "the Board *may* differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern." (emphasis supplied). Congress included this language in § 4(c)(8) because it believed that de novo entry generally has greater procompetitive effect than does entry through the acquisition of an existing competitor. *See* S. Rep. No. 1084, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 5519, 5534; H.R. Conf. Rep. No. 1747, *supra*, 1970 U.S. Code Cong. & Ad. News at 5568. SIA argues that, because many of the benefits expected to result from BAC's acquisition of Schwab could equally be achieved through de novo entry by BAC into retail brokerage, the Board must require de novo entry. We do not agree. Congress did not favor de novo entry as a goal in itself, but as a means of maximizing the procompetitive effects of activities conducted under § 4(c)(8). Here, the Board found that BAC's acquisition of Schwab will not substantially lessen competition, and will likely produce public benefits that outweigh possible adverse effects. Where, as here, entry by acquisition promotes competition as effectively as would de novo entry, and involves no significant anticompetitive effects that de novo entry would avoid, the Board has discretion to permit entry by acquisition.

The petition for review is denied; the order of the Board is affirmed.

THE FEDERAL RESERVE SYSTEM

BankAmerica Corporation

Order Approving Acquisition of Retail Discount Brokerage Firm

BankAmerica Corporation, San Francisco, California ("BAC"), a bank holding company within the meaning of the Bank Holding Company Act (the "BHC Act"), has applied for the Board's approval under section 4(c)(8) of the Act (12 U.S.C. § 1843(c)(8)) and section 225.4(b)(2) of the Board's Regulation Y (12 C.F.R. § 225.4(b)(2)) to acquire 100 percent of the voting shares of The Charles Schwab Corporation, San Francisco, California, a company that engages, through its wholly-owned subsidiary, Charles Schwab & Co., Inc. ("Schwab"), in retail discount securities brokerage, extending margin loans, and other incidental activities. None of the proposed activities is among those that the Board has designated in Regulation Y as being closely related to banking and thus permissible for bank holding companies under section 4(c)(8) of the Act.

Notice of the application, affording interested parties an opportunity to submit comments and views, was duly published in the *Federal Register*. In response to its request for comments on this application, the Board received 17 written comments opposing the acquisition, and 82 favoring the acquisition, including comments from the Department of Justice, the Comptroller of the Currency, and the Securities and Exchange Commission. Among the comments opposing the proposal were those of the Securities Industry Association (the "SIA"), a national trade association representing over 540 securities brokers, dealers, and investment banking organizations. The SIA requested that the Board either deny, or order a formal hearing on, BAC's application.

On July 6, 1982, the Board issued an order scheduling a formal public administrative hearing on BAC's proposal. The

Board's hearing order observed that, while the questions raised by the various comments and protests to BAC's application might appropriately be resolved through additional written submissions, a formal hearing would provide an appropriate and expeditious method for developing a full record for Board consideration of any disputed material facts. The Board's order established an expedited briefing and hearing schedule. With the consent of the parties to the hearing, the United States Department of Justice was permitted to intervene as a party by order dated August 20, 1982.

A formal public administrative hearing, conducted in accordance with the Board's Rules of Practice for Hearings (12 C.F.R. Part 263), was held on September 8, 9, 10, 14, 15, and 16, 1982, in Washington, D.C., before an Administrative Law Judge appointed at the request of the Board. A substantial record on the application was developed through the submission of exhibits and testimony and through the participation of the SIA, BAC, the Department of Justice, and other interested parties.

In a Recommended Decision dated November 12, 1982, Administrative Law Judge Ernest G. Barnes concluded, based upon the evidence of record, that BAC's application met the criteria of section 4(c)(8) of the Act and, accordingly, recommended that the Board approve the application without condition. The SIA and BAC timely filed exceptions to the Administrative Law Judge's Recommended Decision.

Having carefully considered the entire record of the proceeding, including the comments received, and the transcript, exhibits, written testimony, rulings, and briefs filed in connection with the hearing, the Recommended Decision filed by the Administrative Law Judge, together with the exceptions thereto, the Board has determined that the Administrative Law Judge's findings of fact, conclusions, and recommendations, as modified and supplemented herein, are fully supported by the evidence of record and should be adopted as the findings and conclusions of the Board.

BAC, with total consolidated assets of $120.5 billion is one of the two largest banking organizations in the United States.[1] BAC operates one subsidiary bank, Bank of America N.T. & S.A., San Francisco, California ("Bank"). Bank, with domestic deposits of $51.9 billion,[2] is the largest commercial bank in the United States. BAC also operates numerous nonbanking subsidiaries located throughout the United States and abroad, including subsidiaries engaged in consumer and commercial lending, mortgage banking, leasing, data processing, investment advisory services, and certain credit-related insurance underwriting and insurance agency activities in California.

Schwab is a retail discount securities brokerage firm headquartered in San Francisco, California. Schwab operates 51 offices in 26 states and the District of Columbia, and has recently opened an additional office in Hong Kong. Schwab is a member of, and maintains seats on, various national and regional securities exchanges, including the New York Stock Exchange, the Chicago Board Options Exchange, and the Pacific Stock Exchange, and is registered with the Securities and Exchange Commission pursuant to section 15 of the Securities Exchange Act of 1934. Schwab buys and sells securities solely as agent, on the order and for the account of customers. Schwab does not purchase or sell securities for its own account except to an insignificant extent, does not engage in dealing or underwriting, and gives no investment advice. Schwab characterizes itself as a "discount" broker because its commissions are significantly lower than those charged by full-time brokers. In addition to brokerage services, full-line brokers offer investment advice. A Schwab customer is not assigned a personal representative but deals with any available representative, who in many cases enters the customer's order in an automated execution system, which can execute the order in as short a time as thirty seconds.

1 Asset data are as of September 30, 1982.

2 Deposit data are as of December 31, 1981.

Schwab also extends credit for the purchase and carrying of securities and provides securities custodial services and various other services related to maintaining customer accounts, such as individual retirement accounts, a "sweep" arrangement with an unaffiliated money market mutual fund, payment of interest on net free balances awaiting investment, and third party payment services.

Schwab's Activities Are Closely Related to Banking

Section 4(c)(8) of the BHC Act permits a bank holding company to engage, directly or through a subsidiary, in activities that the Board, after due notice and opportunity for a hearing, has determined by order or regulation to be "so closely related to banking . . . as to be a proper incident thereto." The statutory standard requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must determine that the activity is, as a general matter, "closely related to banking." Second, the Board must find in a particular case that the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits that outweigh possible adverse effects.

Based on guidelines established in *National Courier Association* v. *Board of Governors*,[3] a particular activity may be found to meet the "closely related to banking" test if it is demonstrated that (1) banks generally have in fact provided the proposed activity; (2) banks generally provide services that are operationally or functionally so similar to the proposed activity so as to equip them particularly well to provide the proposed activity; or (3) that banks generally provide services that are so integrally related to the proposed activity as to require their provision in a specialized form. However, the *National Courier* guidelines are not the exclusive basis for finding a close relationship between a proposed activity and banking.[4]

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3 516 F.2d 1229, 1237 (D.C. Cir. 1975).

4 *Id.*

A. *Retail Securities Brokerage*

The undisputed facts of record demonstrate that many banks currently offer certain types of securities brokerage services. Many banks provide informal brokerage services, in which, as an accommodation to their customers, banks transmit customer orders to buy or sell securities selected by their customers to brokers for execution. In addition, banks, through the trading desks of their trust departments, routinely buy and sell securities as agent for trusts and other accounts managed by banks.[5]

As the SIA points out, Schwab's activities differ somewhat from the brokerage functions usually performed by banks: Schwab executes orders for the purchase or sale of securities directly, without the assistance of an intervening broker; and executes directly on the exchange orders involving securities listed on such exchanges. The Board finds, however, that Schwab's brokerage services are operationally and functionally very similar to the types of brokerage services that are generally provided by banks and that banking organizations are particularly well equipped to provide such services.[6]

The record shows that, as part of their current services, banks often execute orders involving securities not listed on an exchange by dealing directly with dealers making a market in the particular security or with other third parties. In performing these services, banks exercise the same type of discretion and judgment with respect to the best method of execution that brokers do with respect to similar types of orders. Moreover, many banks use a number of brokers to execute orders placed

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5 Banks also administer employee stock purchase, dividend reinvestment, and automatic investment service plans, which involve the periodic purchase of a particular security or securities from a fixed list of securities, on behalf of a customer.

6 The Board has found that the execution of unsolicited orders to buy or sell securities primarily of Israeli corporations solely as agent of the customer by a company that is not a member of a securities exchange is closely related to banking. *JCT Trust Company, Ltd.*, 67 Federal Reserve Bulletin 635 (1981).

with the bank by its customers or trust department. The record shows that in selecting a particular broker to execute a given order (especially in the case of orders for a block of securities), these banks make the decision themselves as to the best method of execution, leaving to the broker only the technical execution of the transaction. The Securities and Exchange Commission's 1977 report on bank securities activities found that bank trust department trading desks, at least at the largest banks, perform the same functions, utilize the same execution techniques, employ personnel with the same general training and expertise, and use the same facilities, *e.g.*, the consolidated tape, Quotron, AutEx, and other market information services, that brokers do.

In addition, national banks are expressly authorized by statute to purchase and sell securities without recourse, solely upon the order, and for the account of, customers. 12 U.S.C. § 24 Seventh. This authority supports the conclusion that Schwab's brokerage activities, which are within the plain meaning of the language of this authorization, are closely related to banking.[7]

Although the record indicates that in 1977 generally only the largest banks employed sophisticated securities trading procedures and resources, the record also shows that the technological changes in the securities markets and other developments have forced bank securities traders in large banks to develop and expand their skills and that this trend is expected to continue.[8] The Board finds that the use of sophisticated tech-

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7 The SIA asserts that this statutory authorization is limited to providing accommodation brokerage services to existing customers of the bank. Even if this assertion were correct, the fact that an activity is not permitted to a bank does not preclude a finding that the activity is *closely related* to banking and thus permissible for a bank holding company. *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46, 64 (1981).

8 Schwab also maintains customers' accounts and clears and settles executed transactions. Banks perform these functions in connection with the buy or sell orders banks effect for trust departments and as an accommodation to their customers. In addition, as a retail broker,

niques, resources and personnel to execute orders for the purchase or sale of securities for the account of customers is sufficiently widespread in the banking industry to justify a finding that banks generally provide securities execution services that equip them to offer the type of retail brokerage services provided by Schwab. Moreover, the Board finds that execution "in the crowd" on an exchange[9] is a largely ministerial function that involves no greater expertise or resources than the execution of orders directly with third party market makers, which banks generally now perform.[10]

The conclusion that Schwab's brokerage activities are closely related to banking is also consistent with the purposes of the BHC Act, which mandates the separation of banking from commerce in order to guard against the potential concentration of financial resources, conflicts of interest in the control of credit, and risks to insured depository institutions that are likely to result from the control by banking organizations of commercial enterprises. The laws restricting bank involvement in the investment banking business generally, while expressly recognizing that banks have been historically involved in some

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Schwab deals directly with the public to a far greater extent than the typical bank that offers securities brokerage services. However, the Board concludes that the degree of contact with the public does not substantially alter the type of expertise and judgment necessary to perform execution services, which in the case of both Schwab and banks generally is substantially the same.

9 Exchange members that are specialists in particular securities may exercise significant discretion and judgment with respect to trading in those securities. Specialists, however, trade for their own account. Schwab does not buy or sell securities for its own account and is not, therefore, a specialist on any exchange.

10 The fact that in many cases banks rely on brokers to execute customer orders placed with the bank does not preclude a finding that banks are well equipped to execute these orders directly, since the record shows that to a significant extent banks do effect buy and sell orders directly without the intervention of a broker or employ the broker merely to carry out the decision as to the method of execution made by the bank.

types of securities activities, are also designed to avoid conflicts of interest and risks to the safety of depository institutions.

B. *Margin Lending*

Schwab also engages in the extension of margin credit to Schwab's brokerage customers for the purchase and carrying of securities. Banks generally and traditionally have extended credit to their customers for the purpose of buying and carrying securities. At the end of 1981, banks had outstanding approximately $5 billion in loans to borrowers other than securities firms or financial institutions for the purpose of purchasing or carrying securities. In addition, the extension of credit secured by stock and other collateral has long been an important bank activity. The Board's margin credit regulations apply both to brokers such as Schwab (Regulation T) and to banks (Regulation U).[11] While Regulations T and U impose somewhat different requirements, the underlying margin credit activity engaged in by both banks and brokers is functionally the same. The Board therefore concludes that Schwab's margin lending activity is closely related to banking.

C. *Maintenance of Customer Securities Accounts*

In connection with carrying accounts of its securities brokerage customers, Schwab offers various services to its brokerage customers. These services include: (1) Individual Retirement Accounts, for which an unaffiliated savings and loan association serves as trustee; (2) a "sweep" arrangement, pursuant to which idle customer balances exceeding a predetermined minimum are automatically invested in an unaffiliated money market mutual fund; (3) the payment of interest on net free balances awaiting investment; and (4) the "Schwab-One Account," which combines the payment of interest on free credit balances with customer access to such balances through a debit card and checking account offered under an arrangement with

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11 12 C.F.R. Parts 220, 221.

an unaffiliated commercial bank. These services are increasingly being offered by other brokerage firms. The Board finds that each of these services is identical, or functionally and operationally equivalent to, services generally offered by banks to customers directly or through banks' trust departments. Accordingly, the Board finds, on the facts of this case, that BAC's provision through Schwab of IRA accounts, a money market sweep, and the "Schwab One Account" is closely related to banking as well as an incidental activity in connection with Schwab's securities brokerage and margin lending activities.

D. *Custodial Services*

Schwab also provides various types of securities custodial services, involving the safekeeping of customers' securities, accounting for dividends or interest received on such securities, and other ancillary services. Banks generally offer securities custodial services in connection with their trust department and other securities transaction services. In addition, in extending margin credit, a lender is required to maintain custody of the securities pledged to the lender as collateral to secure the loan. Accordingly, the Board finds that the provision of securities custodial services is closely related to banking and is a necessary incident to permissible margin lending activities.

"Proper Incident"—Net Public Benefits

With respect to the "proper incident" requirement, section 4(c)(8) of the Act requires the Board to consider whether the performance of the proposed nonbanking activity by an affiliate of a bank holding company "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." The Board finds that consummation of this proposal can reasonably be expected to result in public benefits outweighing possible adverse effects.

A. *Public Benefits Are Likely to Result from the Proposal*

1. *Increased Competition*

The record shows that the proposed acquisition is likely to make Schwab a more effective competitor in the retail brokerage market. It is likely that the proposal will strengthen Schwab as a competitor by affording Schwab greater acceptability by the public. The record indicates that discount brokers in general are hampered competitively, at least to some extent, because of a lack of public awareness and acceptance of their services due, in large part, to the relatively recent emergence of discount brokers and their lack of extensive office networks. Schwab's affiliation with BAC, a large, internationally recognized and diversified banking and financial services company with substantial resources, can reasonably be expected to result in enhanced public recognition and confidence in Schwab in particular, and discount brokers in general.

As a relatively new and small company, Schwab needs capital in order to expand its office network and facilities. It is undisputed that, because of its affiliation with BAC, Schwab expects to be able to obtain funds at a lower cost and more efficiently than at present.[12] The proposal is also likely to provide Schwab with access to BAC's managerial and technological resources, which, in view of BAC's size and expertise, are likely to assist Schwab in becoming a more effective competitor.[13]

Strengthening Schwab as a competitor is likely to have a procompetitive impact on price competition in the retail bro-

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12 The SIA's claim that Schwab currently has no difficulty in raising capital is immaterial (even if true), since an improvement in the cost and methods of raising funds is likely to produce an increase in Schwab's ability to compete for brokerage services. As explained below, the anticipated improvement in funding would not result in any unfair competitive advantage, because, among other things, BAC, not Bank, would provide funds to Schwab.

13 BAC has an extensive network of offices in this country and in many other countries and plans to assist Schwab in opening new offices.

kerage industry.[14] Since Schwab, like other discount brokers, competes primarily and aggressively on the basis of price, the strengthening of Schwab may induce full-line brokers to compete more vigorously for brokerage business on the basis of price. It is uncontested that the lower commission rates charged by discount brokers are taken into account by full-line brokers. The Recommended Decision forecast that this acquisition might produce a major change in the price structure of the brokerage industry by causing full-line brokers to "unbundle" their services. However, the evidence in the record is not substantial either in support of or against such a change. In any event, the acquisition is likely to have some procompetitive effect.

With respect to the likelihood of increased competition in the development of technology and in the provision of new combinations of financial services, the record indicates that Schwab has developed one of the most sophisticated automated order execution systems in the industry, which is important to Schwab's competitive efforts. Since this type of automated technology is rapidly developing and requires large financial resources to support such development, Schwab's access to BAC's funding support and technical resources can aid Schwab in continuing to offer efficient automated systems, which is likely to have a procompetitive effect throughout the industry.

2. *Increased Convenience and Efficiencies*

With respect to projected increases in convenience and efficiencies, the record shows that BAC will assist Schwab in adding new offices, some of which may be at locations where Bank has branches or where BAC's other nonbank subsidiaries have offices. While most of Schwab's brokerage business is done by telephone or mail, there is evidence in the record that some office locations are necessary to provide effective service.

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14 The SIA claims that there already is active price competition among retail brokerage firms. However, the fact that a market already is competitive does not preclude any further increase in competition.

Customers can make payments and deposit securities at Schwab offices without the inconvenience or cost of, or risk of nondelivery by, mail.

Moreover, the acquisition will permit Schwab and BAC to share their capital, managerial, technological, and marketing resources. In addition, by facilitating joint purchases or securities brokerage and other financial services, the acquisition can be expected to result in lower consumer search costs and greater efficiency in the purchase of such services.

In summary, the Board finds that this acquisition can reasonably be expected to result in some significant public benefits in the form of intensified competition, increased efficiency, and greater consumer convenience in the provision of retail securities brokerage services to the public.

B. *Lack of Significant Adverse Effects*

Having considered the facts of record and the allegations of all of the parties, the Board finds that the proposal is not likely to result in any significant adverse effects.

1. *Unlikelihood of Undue Concentration of Resources or Decreased Competition*

Assessment of the potential competitive impact of this proposal begins with a definition of the relevant product and geographic markets. The relevant product market includes all products that are reasonably interchangeable in practical function and use.[15] It is not disputed that retail securities brokerage constitutes a relevant product market. The SIA contends that discount securities brokerage is a relevant product submarket.[16] Based on the facts of record, the Board concludes

15 E.g., *United States* v. *E.I. duPont de Nemours & Co.*, 351 U.S. 377, 395 (1956).

16 The existence of a product submarket is determined by examining such practical indicia as industry or public recognition as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors. *Brown Shoe Co.* v. *United States*, 370 U.S. 294, 325 (1962).

that discount brokerage is not a sufficiently unique product to be considered a separate submarket. The record shows that some discount brokers offer investment advice in addition to the execution of buy and sell orders, while some full-line brokers offer discount brokerage services to large, active retail customers. According to the record, discount and full-line brokers are viewed by the public as reasonable substitutes, since many of Schwab's new customers are gained from full-line brokers, while Schwab has lost customers to full-line brokers.

The relevant geographic market is comprised of the market area in which the seller operates and to which the purchaser can practicably turn for supplies.[17] With 51 offices in 26 states and the District of Columbia, Schwab operates nationwide. Schwab is licensed to do business in all fifty states, has a uniform nationwide pricing policy, and advertises chiefly in nationwide financial publications. Customers can obtain access to Schwab's service from any place in the country by calling a toll-free telephone number. Based on this and the other evidence of record, the Board finds that the relevant geographic market for purposes of this proposal is the United States.[18]

The Board finds that this acquisition will not result in any significant reduction of competition or any increase in concentration of resources to an undue level in any relevant market. With respect to undue concentration of resources, while BAC has substantial assets ($112.9 billion in 1981), Schwab is not of significant asset size ($104 million). BAC's acquisition of

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17 *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 359 (1963).

18 The SIA claims that the State of California is the relevant geographic market on the theory that that area represents the area of competitive overlap between BAC and Schwab. This contention ignores the fact that Schwab and BAC each compete in different product markets. For similar reasons, the SIA's contentions regarding the inclusion of nonbank financial institutions in the banking product market are immaterial, since Schwab, the firm to be acquired, does not engage in banking activities.

Schwab (an increase of less than one per cent in BAC's assets) would not result in any unwarranted increase in the concentration of resources controlled by BAC.

The record indicates that Schwab's acquisition by BAC would not eliminate any significant existing competition in the nationwide retail brokerage market.[19] Schwab's share of the retail brokerage market, expressed in terms of a percentage of total commissions in that market, is less than one per cent. Bank's brokerage activities, primarily an accommodation for existing customers and employees, do not represent a significant market share.[20] While BAC may be viewed as a potential entrant into the retail securities brokerage market, that market is unconcentrated and characterized by low barriers to entry and numerous potential entrants.

The SIA notes that BAC anticipates an increase in Bank's deposits after the acquisition as a result of cross-selling Bank's services to Schwab's customers. While significant concentration exists in some local California banking markets and BAC's market share in those markets is significant, this acquisition will not directly cause any increase in Bank's deposits in any market. Such an increase, if it occurs, would result from success in cross-selling by BAC. In any event, the projected increase in Bank's deposits is of *de minimis* proportions.[21]

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19 Both Bank and Schwab engage in extending margin credit for the purchasing and carrying of securities. To the extent margin lending is a separate product, the proposal would not eliminate any significant competition. Neither Bank's nor Schwab's outstanding margin loans are substantial.

20 There is no substantial record evidence that the Board's conclusion concerning lack of elimination of potential competition would be altered even if discount brokerage were viewed as a product submarket. The record does not indicate that such a submarket is highly concentrated or that the number of potential entrants is low. Indeed, recent developments suggest that many banks must now be viewed as likely entrants into any such discount brokerage submarket.

21 It is not likely that BAC would gain significant competitive advantage from the projected growth in Bank's deposits since other large California banks, *i.e.*, Security Pacific National Bank and Crocker

The SIA contends that BAC's acquisition will eliminate competition in the brokerage product market by forcing other discount brokers either to become affiliated with a banking organization or be driven from the market. There is no evidentiary support for this allegation. However, even if the SIA's hypothesis is correct, it does not necessarily lead to the conclusion that competition will be diminished as a result. Indeed, such affiliations are likely to increase the vigor of competition. Moreover, the SIA does not contend that the acquisition will preclude any further entry into the retail brokerage market.

2. *Unlikelihood of Unfair Competitive Practices*

The SIA contends that, as a result of the acquisition, Schwab would have an unfair advantage over other brokers in the rates Schwab would pay for its funding. BAC plans to provide funding to Schwab by lending to Schwab the proceeds of funds raised directly by BAC. The SIA asserts that, because of explicit and implicit guarantees given by the federal government to the creditors of Bank (BAC's major asset),[22] BAC is able to raise funds at lower rates than brokerage firms that are not affiliated with a bank. According to the SIA, this alleged funding advantage is unfair because it rests on federal guarantees unavailable to brokerage firms not affiliated with banking organizations.[23] The SIA also argues that after the acquisition Schwab could obtain funds from BAC at rates lower than it currently pays and that this reduction in funding costs is not economically justified. The Board finds no significant adverse

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National Bank, have recently entered the retail brokerage field, and other banking organizations are also likely to enter.

22 Creditors of a bank holding company are not protected by federal deposit insurance. The SIA contends, however, that the government would come to the aid of any large bank in difficulty to maintain the stability of the financial system and that such assistance would benefit the parent holding company.

23 Brokerage firms benefit from a federal guaranty, *i.e.*, the Securities Investor Protection Corporation.

effects are likely to result from the proposed method of funding Schwab.

The record does not demonstrate that BAC's costs of funds are significantly lower than those of other corporations of similar resources. For example, the rates paid by BAC on its commercial paper during May through July 1982 were generally the same or higher than rates on commercial paper paid by corporations of similar size and credit ratings. Moreover, any cost advantage in raising funds enjoyed by BAC may be due to economic factors such as BAC's size, capital, and earnings, rather than to any guarantees applying to Bank alleged by SIA.[24] In any event, the Board finds that any advantage Schwab might obtain as the result of its borrowing from BAC is not unfair competition for purposes of section 4(c)(8). The legislative history of that section indicates that the term "unfair competition" was intended to refer to unfair or unethical business conduct (as defined by common law or under state or federal law), not disparities or advantages based on the structure and operations of the banking industry.[25] While the original 1956 BHC Act severely restricted borrowing by a bank holding company (or its nonbank subsidiaries) from its subsidiary bank,[26] Congress expressly declined to prohibit "downstream" financing, *i.e.*, borrowing by any subsidiary in the system from the parent. Congress found that downstream

24 BAC states that funds for Schwab would be provided by the parent holding company, not by Bank. Thus, any cost advantage Bank might enjoy because its deposit liabilities are federally insured is immaterial. In any event, it should be emphasized that the extent to which funds from Bank may be transferred to Schwab is strictly limited by section 23A of the Federal Reserve Act. 12 U.S.C. § 371c.

25 H.R. Rep. No. 1747, 91st Cong., 2d Sess. 18-19 (1970). The legislative history identified such practices as intimidation of customers and commercial espionage. *Id.*

26 70 Stat. 133, 137. These limitations were repealed in 1966 on the grounds that they were unnecessary in light of the similar, more flexible restrictions in section 23A of the Federal Reserve Act. 80 Stat. 236, 240; S. Rep. No. 1179, 89th Cong., 2d Sess. 10-11 (1966).

financing is a beneficial advantage of the bank holding company structure and permits the parent holding company to draw on its own capital and funds to strengthen the financial condition of its subsidiaries.[27] Recognizing this advantage, Congress authorized bank holding companies to acquire certain types of *nonbank* subsidiaries, which would compete against firms in the same line of commerce.

Moreover, the Board finds no basis in the SIA's claim that Schwab's ability to obtain low cost funding from BAC is economically unjustified. The Administrative Law Judge found, and the SIA does not contest, that the rate of interest BAC charges its subsidiaries on loans to such subsidiaries reasonably approximates BAC's own cost of funds. Moreover, the fact that the rates at which Schwab would be able to obtain funding might be lower than the rates at which other brokers pay does not *per se* demonstrate that the rates BAC charges Schwab are unfair or unjustified, since other economic factors not applicable to Schwab or BAC (*e.g.*, lower capital or earnings or lack of complete credit information) might justify higher rates paid by other brokers.[28]

The SIA also asserts that BAC intends to cross-sell banking services to Schwab customers, and thus has an incentive to subsidize Schwab's brokerage business. Cross-subsidization is an unfair competitive practice that occurs when the profits of one company are used to enable an affiliated company to offer its services at prices below its costs.[29] Cross-subsidization is successful, and therefore a likely practice, only where a company offering below-cost pricing has sufficient market domi-

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27 S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955).

28 The Board does not accept the SIA's contention that BAC will lend funds to Schwab without regard to the risk involved. The record indicates that BAC does account for risk in determining the amount of funds to advance to a nonbank subsidiary and in determining whether an appropriate return will be earned on such advances.

29 *E.g.*, *Citicorp (Citishare)*, 68 Federal Reserve Bulletin 505, 512 (1982).

nance to be able to eliminate competitors by sustained below-cost pricing and thereafter to raise prices to recover the losses incurred through offering services below cost. It is clear from the record that Schwab does not have such a dominant position in the retail brokerage market and that the industry has very low barriers to entry. There is no evidence that BAC plans to offer brokerage services through Schwab at below Schwab's costs. The evidence shows that BAC expects Schwab to provide a positive return on equity.[30] The record evidence showing that BAC intends to cross-sell banking services to Schwab brokerage customers does not in itself demonstrate that BAC will cause Schwab to offer services at below cost.

Bank serves as a dealer in municipal securities. After the announcement of this proposal, BAC and Schwab entered into an arrangement under which Schwab provides its customers with information on municipal securities Bank holds in its inventory. The SIA contends that, since bank dealers in municipal securities enjoy more favorable tax treatment than nonbank dealers,[31] the arrangement between Schwab and Bank would permit Bank to exploit this allegedly "unfair" competitive advantage. However, the Board finds that any such competitive advantage results from the application of the federal tax laws, which affect all participants in the municipal securi-

30 The SIA contends that BAC will have an incentive to subsidize Schwab's services because SIA expects that some Schwab customers will bring business to Bank and that Bank's earnings from this increased business will be greater than the losses caused by offering brokerage services at below cost. This contention, in the Board's view, is not based on any evidence in the record. The Board also notes that competition by financial institutions for deposits is strong, making it unlikely that Bank would be able to attain profit levels on deposits by customers of Schwab that would justify cross-subsidization. Moreover, in this connection, the Board notes that federal limitations on interest rates payable on deposits are being rapidly eliminated, resulting in increases in the cost of deposits.

31 The interest paid by nonbank dealers on funds borrowed to finance their inventory of municipal securities is not deductible for federal income tax purposes. 26 U.S.C. § 265(2). Bank dealers are exempt from this provision.

ties markets, and does not represent the type of adverse effect about which the BHC Act was concerned.

The Board further finds that the risk of voluntary tying of bank credit to use of Schwab's brokerage services is not substantial, given existing legal,[32] regulatory and internal BAC safeguards, and the record facts. Voluntary tying results when a customer believes that he or she stands a better chance of obtaining a scarce product by purchasing another product or service from the same seller. Where both products are in ample supply, voluntary tie-ins are not likely. These implicitly coerced joint sales are different from voluntary joint sales which, as the Administrative Law Judge found, can result in benefits to the customer by reducing search costs for the consumer and increasing efficiencies inherent in joint production and sale.

As the Board has previously found, the likelihood of voluntary tying depends on market structure and on the offering of a product that is relatively scarce.[33] The possibility of such tying is significantly reduced in competitive markets where there is a large number of alternative sources of the product involved (*e.g.*, credit). The Board finds that there are many alternative sources of credit (both bank and nonbank) available to the customers (mostly individuals) that are likely to use a discount broker like Schwab.

The SIA claims that because BAC intends to promote Schwab's services and because Bank's pricing of loans or other services, as a matter of policy, takes account of a customer's relationship with a nonbank subsidiary in the BAC system, there is the likelihood of implicitly coerced joint sales. The record shows that employees of Bank are expressly advised not

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32 Explicitly coerced joint sales are expressly prohibited by section 106 of the BHC Act Amendments of 1970, 12 U.S.C. §§ 1972-78, and are not an issue in this application.

33 *E.g.*, *Citicorp (Person-to-Person Financial Center)*, 67 Federal Reserve Bulletin 443, 446 (1981). There is no evidence that brokerage services are such a scarce service that brokerage customers of Schwab will feel implicitly coerced into seeking deposit or credit services of Bank in order to continue to obtain brokerage services from Schwab.

to create even the impression that a customer might enhance the likelihood of obtaining a desired service by purchasing other products or services from Bank or its affiliates. Moreover, the record shows that customers of Bank that would be likely to use a discount broker are also likely to be (as are Schwab's current customers) relatively knowledgeable about financial matters. Such customers are less likely to be implicitly coerced into using brokerage services that are not independently desired. The Board does not believe the evidence suggests the likelihood of significant coerced joint sales.

3. *Unlikelihood of Other Adverse Effects*

The Board finds no persuasive evidence that BAC's acquisition of Schwab would result in significant conflicts of interest. The possibility that Bank might make unsound loans to Schwab customers to maximize Schwab's profits is not substantial and is neither based on evidence nor reasonable. Moreover, it would not be rational for Bank to place its own funds at risk in an unsound loan merely to increase brokerage commissions earned by Schwab. The Board finds no realistic basis for the SIA's contention that Schwab might "dump" worthless municipal securities on its customers as a result of its arrangement with Bank's municipal securities dealer operations. Under this arrangement Schwab identifies for its customers municipal securities held in Bank's inventory and does not give investment advice concerning the purchase or sale of the securities. There does not appear to be any substantive basis for any conflicts of interest arising from this procedure. Nor is there any credible evidence that Bank would breach its fiduciary duty by placing orders with Schwab for the purchase or sale of securities by Bank's trust department or customers where Schwab would not effect the best execution of the order.[34] There is no record evidence suggesting that Bank

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34 Bank's trust department is subject to a judicially enforceable duty to obtain best execution of orders under applicable statutes (15 U.S.C. § 78bb(e)(2)) and related regulations of its federal supervisor. 12 C.F.R. § 9.5, 47 Fed. Reg. 27831 (1982).

would use Schwab's services in situations that would result in a breach of fiduciary duty.

The earnings of discount brokers are heavily dependent on the volume of trading in securities and have fluctuated to a significant degree. However, the SIA's claim that Schwab is a high risk enterprise and that BAC might be compelled to make unsound loans to shore up Schwab is not supported by the record. Despite fluctuations in earnings, discount brokers in general, and Schwab in particular, have been profitable. Schwab's income has grown significantly in recent years. Schwab is not a speculative enterprise and the financial risks to BAC as a result of this proposal do not appear to be any greater than the risks involved in other permissible nonbank activities. The Board finds that it is unlikely that significant financial risks to BAC or Bank would result from the proposal.

The Board finds no basis for the SIA's contention that, because BAC intends to advertise its affiliation with Schwab, the proposed acquisition would result in public confusion. There is no evidence that BAC would misrepresent the nature of Schwab's affiliation with BAC or Bank, and BAC should assure that fully adequate disclosure of the status of Schwab obligations is made available to all customers.

The SIA further contends, without any evidentiary record for its claim, that Schwab solicits customers to place funds in Schwab's cash management account solely to earn interest and not for purchasing securities, that such funds might not be protected by Securities Investor Protection Corporation insurance (a protection that Schwab advertises), and that such an account constitutes the unlawful taking of deposits. The Board finds no basis for this allegation on the facts of this case. Guidelines issued by the Securities and Exchange Commission restrict registered brokers, such as Schwab, from soliciting funds solely to earn interest.[35] The rules of the New York Stock Exchange prohibit a member (such as Schwab) from paying interest on any free credit balance created for the purpose of

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35 3 Fed. Sec. L. Rep. (CCH) ¶ 25,134B.

receiving interest.[36] There is no evidence that Schwab will not comply with these limitations or that Schwab's advertising of SIPC insurance will be materially misleading.

In the exercise of its responsibility under the BHC Act, the Board has carefully considered whether BAC's financial and managerial resources are adequate to effect the proposed acquisition. In its evaluation of BAC's financial resources, the Board has reviewed all the relevant data concerning BAC's financial condition. Based upon this review, the Board concludes that the proposed acquisition would not represent a significant additional burden on BAC's financial resources. The Board notes the improvement in BAC's capital over the past year and expects that BAC will continue its efforts to improve its capital position. On balance, the Board concludes that BAC has both financial and managerial resources that are consistent with approval.

In sum, the Board finds that this acquisition may reasonably be expected to result in public benefits that outweigh possible adverse effects. Accordingly, since this acquisition satisfies both the "closely related" and the net public benefits tests of section 4(c)(8), the Board finds no basis for the SIA's contention that BAC must be required to enter the retail securities brokerage industry *de novo*.[37]

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36 *Id.*

37 The decisions cited by the SIA where the Board has denied the acquisition of a going concern by a bank holding company with the resources for *de novo* entry are inapposite. In those cases, the Board expressly found that acquisition of the going concern would eliminate substantial potential competition. *BTNB Corp.*, 58 Federal Reserve Bulletin 70, 71 (1972); *Marine Bancorporation*, 58 Federal Reserve Bulletin 504, 505 (1972); *Crocker National Corp.*, 58 Federal Reserve Bulletin 419, 420 (1972). Section 4(c)(8) does not require *de novo* entry by a bank holding company if, as here, the company's acquisition of a going concern will not substantially lessen competition and is likely to produce benefits that outweigh possible adverse effects.

The Acquisition Is Consistent with the Glass-Steagall Act

The SIA and various other commenters contend that the acquisition of a securities brokerage firm by a bank holding company is prohibited by provisions of the Glass-Steagall Act, the popular term for provisions of the Banking Act of 1933, that insulate commercial banking from certain aspects of the securities business. Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of any bank that is a member of the Federal Reserve System with any corporation or similar organization that is "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities.[38] For the reasons stated and upon the findings made in this Order, the Board concludes that Schwab is not engaged principally in any of the activities prohibited to member bank affiliates by the Glass-Steagall Act and accordingly concludes that this acquisition is consistent with the letter and spirit of that Act.

As a result of the consummation of this proposal, Bank, a member bank, would become affiliated with Schwab for purposes of section 20.[39] The SIA alleges that Schwab is engaged principally in the "public sale" of securities within the proscription of section 20 by virtue of its retail brokerage activities.[40] The Board finds, however, that the business of purchasing or selling securities upon the unsolicited order of, and as agent for, a particular customer does not constitute the

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38 Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 Seventh, provides that a national bank's dealing in securities and stock is limited to "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers" and not for the bank's own account [illegible] that a national bank "shall not underwrite any issue of [illegible] stock." Section 21, U.S.C. § 378, prohibits any organi[illegible]s deposits to engage at the same time "in the business [illegible]rwriting, selling, or distributing" securities.

39 12 U.S.C. § 221a(b)(2).

40 It is undisputed that Schwab's brokerage activities do not constitute the "issue, flotation, underwriting . . . or distribution" of securities.

"public sale" of securities for purposes of section 20. It is significant that, in describing proscribed activities of bank affiliates, section 20 does not mention "brokerage" activities, the generic term commonly associated with the business of buying and selling securities as agent for a customer.[41] In addition, in executing a customer's order to buy or sell securities, a broker does not make a public offer or hold itself out to the public as a seller or buyer for its own account but only acts as agent to assist the seller or buyer.[42] Furthermore, the terms "issue," "flotation," "underwriting," and "distribution" (used in section 20 in conjunction with "public sale") generally refer to the process by which new issues or large blocks or securities are distributed to the public, not to brokerage functions, which are primarily concerned with the transfer of securities at the request of a particular customer.[43] The term "public sale" used in association with this series of terms should be given a meaning similar to those terms since, under the rules of statutory construction, words grouped in a list should be given a related meaning.[44]

The view that "public sale" was not intended to apply to purchasing or selling securities as agent for a customer is further supported by the fact that the Board has consistently interpreted section 32 of the Glass-Steagall Act (12 U.S.C. § 78) as not applying to any brokerage activities. Section 32

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41 2 L. Loss, *Securities Regulation* 1215 (2d ed. 1961). A securities *dealer* sells securities it has purchased for its own account elsewhere or purchases securities for its own account with a view toward selling them elsewhere. *Id.* A dealer ordinarily maintains an inventory of particular issues of securities and holds itself out to the public as being willing to purchase or sell such securities for its own account. A dealer is thus unlike a broker, which acts for the account of a customer.

42 *Cf.* Securities and Exchange Commission, Final Report on Bank Securities Activities 121-22, 167 (1977).

43 1 L. Loss, *supra* at 159-72.

44 *E.g.*, *Third National Bank in Nashville* v. *Impac, Ltd.*, 432 U.S. 312, 322 (1977).

prohibits managerial interlocks between a member bank and a firm primarily engaged in the same securities activities described in section 20. Beginning in 1936, the Board's Regulation R, which implements the provisions of section 32, has consistently provided that "[a] broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32."[45] Since section 20 and section 32 are part of the same statute and were enacted for the same purpose, the meaning of "public sale" as used in section 20 should be interpreted consistently with the same term in section 32.[46]

The SIA and other commenters contend that Schwab's retail brokerage activities are prohibited to banks under section 16 of the Glass-Steagall Act and thus should not be permitted to affiliates of banks. However, as the Supreme Court has made clear, section 20 determines the permissible securities activities of an affiliate of a bank and the fact that a bank might be precluded from engaging in a particular securities activity does not necessarily mean that a bank holding company is precluded from performing such service.[47] Moreover, section 16 *authorizes* national banks to engage in retail brokerage, *i.e.*, to

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45 22 Federal Reserve Bulletin 51 (1936), *codified at* 12 C.F.R. § 218.1 n.1.

46 The Board's view that brokerage activities do not constitute the public sale of securities was implicitly upheld by the Supreme Court in *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947). In *Agnew*, the Court affirmed a Board order finding that a particular securities firm with significant income from both underwriting activities and brokerage activities was "primarily" engaged in underwriting securities and thus covered by section 32. 329 U.S. at 445-46. The Supreme Court affirmed the Board's finding that the firm was primarily engaged in underwriting even though the amount of underwriting done by the firm did not exceed 50 per cent of its business. *Id.* at 447-49. The Court left undisturbed the Board's implicit finding that the brokerage business was not part of the business described in section 32.

47 *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46, 63-64 (1981).

engage in "purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers." 12 U.S.C. § 24 Seventh.

The SIA concedes that section 16 expressly authorizes some securities brokerage activities for banks, but contends, based on early interpretations of section 16 by the Comptroller of the Currency, that national banks are limited to executing orders without profit and only as an accommodation to existing customers, and that Schwab's services, not tied to the customers of any bank, clearly exceed these limitations.[48] However, beginning in 1957, the Comptroller has gradually departed from these early interpretations on the grounds that they are not supported by the express language of the statute, reflected an overcautious approach to bank regulation in the aftermath of the Great Depression, and are erroneous. Indeed, the Comptroller has recently authorized a national bank to establish a subsidiary to engage in discount brokerage services substantially the same as those provided by Schwab[49] and has advised the Board, in comments on BAC's proposal, that a national bank's purchase and sale of securities as agent is permissible under the Glass-Steagall Act.[50] In any event, inde-

48 *See, e.g.*, 20 Federal Reserve Bulletin 609 (1934).

49 Comptroller of the Currency, Decision on the Application by Security Pacific National Bank to Establish an Operating Subsidiary To Be Known as Security Pacific Discount Brokerage Services, Inc. (August 26, 1982). The SIA is seeking judicial review of this decision. Among other things, the SIA has alleged that the establishment by a national bank of brokerage offices at locations where the bank is not permitted to branch violates the National Bank Act. The Board finds that there would be no violation of the federal branching laws in this application under the BHC Act, since Schwab is a separate corporation, has its own capital and officers and directors, and would not be operated in a unitary fashion with Bank, but as a nonbank subsidiary of a bank holding company. *See Grandview Bank & Trust Co.* v. *Board of Governors*, 550 F.2d 415 (8th Cir.), *cert. denied*, 434 U.S. 821 (1977).

50 The SIA argues that Schwab's activities do not meet the "without recourse" requirements of section 16, since in many cases Schwab executes transactions directly without the assistance of an intervening

pendent of the validity of the Comptroller's constructions of section 16, the Board finds that Schwab's brokerage functions do not constitute the "public sale" of securities (or any other proscribed activity) within the meaning of section 20 of the Glass-Steagall Act, the applicable statutory provision.[51]

This conclusion is consistent with the purposes of the Glass-Steagall Act. During congressional consideration of the Glass-Steagall legislation, the scope of permissible bank brokerage activity was not discussed in detail.[52] However, since the types of bank securities activities considered harmful and contrary to public policy were exhaustively catalogued in the legislative history and brokerage activities received no serious attention, it is unlikely that Congress viewed such activities as the target of the Act's prohibitions.[53] Indeed, the particular type of securi-

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broker against whom Schwab's customers might otherwise have recourse for any alleged fraud or negligence. However, in the Board's view, the ordinary commercial meaning of "without recourse" indicates that section 16 prohibits a bank from assuming the liability of endorser or maker with respect to the securities bought or sold as agent of the customer. *See* G. Munn & F. Garcia, Encyclopedia of Banking & Finance 943 (7th ed. 1973; U.C.C. § 3-414(1)). There is no evidence that Schwab would assume any such liability.

51 The SIA further asserts that "public sale" in section 20 must be interpreted similarly to the terms "purchasing and selling" as used in sections 16 and 21, which, the SIA contends, clearly include brokerage functions. However, section 16 expressly permits purchasing and selling securities for the account of customers.

52 The relevant legislative history merely states that national banks would be permitted to buy and sell securities for their customers to the same extent as heretobefore. S. Rep. No. 77, 73rd Cong., 1st Sess. 16 (1933).

53 The SIA's reliance on various statements by a draftsman of the Securities Exchange Act of 1934 is without merit. These statements were made after enactment of the Glass-Steagall legislation, are not the views of a member of the legislature, and do not purport to deal with the outer limits of permissible bank brokerage activities. In addition, the Comptroller of the Currency's explanation of the 1935 amendment to section 16 (which merely clarified that the scope of permissible

ties activities engaged in by Schwab are fully consistent with the objectives of the Glass-Steagall Act. As has been widely recognized, the Glass-Steagall legislation was intended to eliminate the risk of loss or insolvency that may result when a bank purchases securities for resale to the public, makes unsound loans to bolster its marketing of particular securities, or loses public confidence when it becomes apparent that the bank has a "salesman's stake" in the success of a particular investment opportunity.[54] Further, as noted above, the Board believes that Schwab's activities pose no greater risk of failure than other nonbanking activities permitted by the Board to bank holding companies. The Board finds that these types of hazards are not present in connection with Schwab's activities, since, except on very infrequent occasions, Schwab does not purchase or sell securities as a principal, *i.e.*, with its own assets.[55] Nor does Schwab have any interest in the success or failure of any particular issue of securities, since its operations are limited to

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brokerage included execution of orders for stock as well as for debt securities) appears merely to be a statement of the Comptroller's now-rejected administrative interpretation of the 1933 legislation.

54 *E.g.*, *Board of Governors* v. *Investment Company Institute*, *supra*, 450 U.S. at 61-62; *Investment Company Institute* v. *Camp*, 401 U.S. 617, 629-34, 635-38 (1971). The SIA's reliance on the Supreme Court's passing remark in the second *ICI* decision that the ACT was intended to divorce banks from underwriters and brokerage houses, 450 U.S. at 63, is misplaced. Brokerage activities were clearly not at issue in that case. Also, most brokerage firms also engage in dealing in securities, an activity that *is* generally impermissible under the Act. *See* 2 L. Loss, *supra* at 1215.

55 Schwab acts as a principal if it mistakenly purchases securities not authorized by the customer. Such "inadvertent principal" transactions are less than one per cent of Schwab's business and clearly not a principal activity. In addition, in infrequent cases, Schwab may purchase municipal securities in a new issue as riskless principal—with its own assets but only after a firm customer order for such securities has been received. These riskless principal transactions (also not a principal activity of Schwab) appear to be consistent with permissible brokerage activities, and, in any event, section 16 expressly authorizes banks to act as principal with respect to certain types of municipal securities.

providing a service enabling investors to purchase or sell expeditiously securities selected by the customer. Although, as the SIA points out, unsuccessful operations by an affiliate may well damage the reputation of a bank or bank holding company, the Board finds that the likelihood of harm to the reputation of BAC or Bank as a result of this proposal is minimal, since Schwab does not actively promote any particular securities and does not offer investment advice.

Schwab also offers to its customers a "sweep" arrangement, under which idle customer balances awaiting investment and exceeding a predetermined amount are routinely and automatically used to purchase shares of an unaffiliated money market mutual fund. The Board has pending before it a separate petition submitted by the SIA alleging that such "sweep" arrangements by banks constitute the impermissible underwriting of the securities of the money market mutual fund and believes that this issue is more appropriately resolved in that context. Even if it is assumed that Schwab's sweep arrangement constitutes underwriting of the money fund's securities, the record clearly shows that Schwab is not principally engaged in that activity. Thus, no violation of section 20 would arise as the result of the present application.

Proposed Restrictions on Schwab's Activities

The SIA asserts that, if the Board determines to approve the proposal, various restrictions should be imposed to address the alleged adverse effects of the acquisition by limiting Schwab's activities solely to securities brokerage, by restricting the method by which Schwab obtains funds, establishes offices, advertises its affiliation with BAC, and by prohibiting Bank from using Schwab to execute transactions for Bank's fiduciary accounts or to sell municipal securities. For the reasons explained above, the Board concludes that significant adverse effects are not likely to result from the proposal and, accordingly, the Board finds that the imposition of the restrictions advanced by the SIA is not warranted. Because BAC's plans to finance and promote Schwab and to place Schwab offices at

some BAC locations are not likely to produce any unfair competitive advantage, public confusion, or other adverse effects, the Board finds no basis to restrict such activities. Also, Bank's use of Schwab to buy or sell securities as agent for the Bank's trust department or to transmit information on Bank's municipal securities inventory should not be prohibited, since these operations present the prospect of no serious adverse effects.[56]

In approving BAC's application to acquire Schwab, the Board grants approval under the BHC Act only for those activities considered by the Board.[57] Thus, any change or expansion in the activities described in this Order would require the approval of the Board.

Consistency with Objectives of the BHC Act

The Board has reviewed this application from the viewpoint of its basic consistency with the objectives of the BHC Act. This Act was designed to eliminate the potential for conflicts of interest and concentration of resources that are inherent in the commingling of banking and commerce to help maintain banks as impartial providers of credit, to avoid the anticompetitive effects that would inevitably arise from close links between the control and use of credit, and to protect the banking system and ultimately the economy as a whole from the instability that could result from bank participation in commerce. The Board believes that these fundamental considerations retain their essential validity and should continue to guide the evolution of banking services in the changing economic and competitive environment that we have today.

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56 Indeed, a complete prohibition against Bank's use of Schwab's brokerage service could conceivably cause a breach of fiduciary duty in a particular case where Schwab in fact can provide the best execution of the order. Moreover, there is no indication that Schwab will not comply with the limitations that the SEC and other authorities have prescribed on the receipt by brokers of funds solely to earn interest. A similar Board-imposed limitation is unnecessary.

57 12 C.F.R. § 225.4(c)(2).

The Board finds that there is no inconsistency between the basic policies of the BHC Act and the conduct of the nonbanking activity that is the subject of this application. As described in detail in this Order, the Board has found that a securities brokerage service that is essentially confined to the purchase and sale of securities for the account of third parties, and without the provision of investment advice to the purchaser or seller, does not raise the potential for conflicts of interest or concentration of resources that were the object of the prohibitions that were instituted to assure the separation of banking from commerce. Expansion of banking into securities activities must proceed carefully, but the proposed activity raises none of the concern that engenders the need for restrictions on banking or bank holding company activities.

Based upon the foregoing and other considerations reflected in the record, the Board has determined that the public benefits associated with consummation of this proposal can reasonably be expected to outweigh possible adverse effects, and that the balance of the public interest factors, which the Board is required to consider under section 4(c)(8) of the Act, is favorable. Accordingly, the application is hereby approved.

This determination is subject to the conditions set forth in section 225.4(c) of Regulation Y and the Board's authority to require such modification or termination of the activities of a holding company or any of its subsidiaries as the Board finds necessary to assure compliance with the provisions and purposes of the Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.

Because of the extensive consideration accorded to Schwab's securities brokerage, margin lending, and incidental activities in the context of this application, and having determined that the public interest considerations of section 4(c)(8) favor approval of BAC's proposal, the Board has determined that further applications by BAC to extend Schwab's retail discount securities brokerage, margin lending, and incidental activities to additional offices may be processed in the same manner as other *de novo* applications under the provisions of section 225.4(b)(1) of Regulation Y (12 C.F.R. § 225.4(b)(1)). Author-

ity is hereby delegated to the Federal Reserve Bank of San Francisco to take action on such notices properly filed as prescribed in that section.

The proposed activities shall not commence later than three months after the effective date of this Order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of San Francisco.

By order of the Board of Governors,[58] effective January 7, 1983.

(Signed) James McAfee

James McAfee
Associate Secretary of the Board

[SEAL]

58 Voting for this action: Chairman Volcker and Governors Martin, Wallich, Partee, Rice and Gramley. Absent and not voting: Governor Teeters.

RELEVANT PROVISIONS OF THE BANKING ACT OF 1933 (THE GLASS-STEAGALL ACT)

SECTION 16

12 U.S.C. § 24. Corporate Powers of Associations

Upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

* * *

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . . As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, co-partnership, association or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permit-

ted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, or . . .

SECTION 20:

12 U.S.C. § 377. Affiliation with Organization Dealing in Securities; Penalties

After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

SECTION 21:

12 U.S.C. § 378. Dealers in Securities Engaging in Banking Business; Individuals or Associations Engaging in Banking Business; Examinations and Reports; Penalties

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this para-

graph shall not prohibit national banks or state banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further,* That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate;

* * *

SECTION 32:

12 U.S.C. § 78. Certain Persons Excluded from Serving as Officers, Directors or Employees of Member Banks

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

RELEVANT PROVISIONS OF THE BANK HOLDING COMPANY ACT

12 U.S.C. § 1843. Interests in Nonbanking Organizations

(a) Ownership or control of voting shares of any company not a bank; engagement in activities other than banking. Except as otherwise provided in this Act no bank holding company shall—

(1) after the date of enactment of this Act [enacted May 9, 1956], acquire direct or indirect ownership or control of any voting shares of any company which is not a bank,

* * * * * *

(c) Exemptions. The prohibitions in this section shall not . . . apply to—

* * * * * *

(8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern;

Joint Appendix

No. 83-614

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JOINT APPENDIX

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Chronology of Relevant Pleadings, Hearings, and Orders in the Court Below*

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—against—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, et al.,

Respondents,

and

BANKAMERICA CORPORATION,

Intervenor.

ON PETITION FOR REVIEW OF ORDER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

* Because the Clerk of the United States Court of Appeals for the Second Circuit is unable to locate the actual docket of this proceeding, this chronology was prepared by counsel for petitioner based upon a computer-generated "General Docket" provided by the Clerk.

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Chronology

Date	*Filings-Proceedings*
2-3-83	Petition filed for review of final agency action
2-22-83	Pre-argument conference held with Frank J. Scardilli, Staff Counsel
2-22-83	BankAmerica Corp. Motion for Leave to Intervene on Consent
2-25-83	Scheduling Order entered
2-28-83	Certification of Index of Administrative Record filed
3-1-83	Order entered granting Motion to Intervene on Consent
3-16-83	Petitioner's Brief filed
3-16-83	Record materials designated by Petitioner to be included in the Joint Appendix filed
4-11-83	Record materials designated by Respondents to be included in Joint Appendix filed
4-11-83	Record materials designated by Intervenor to be included in Joint Appendix filed
4-11-83	Respondents' Brief filed
4-11-83	Intervenor's Brief filed
4-25-83	Petitioner's Reply Brief filed
5-23-83	Argued before Feinberg, C.J.; Lumbard, and Winter J.J. (15 minutes allocated to each side)
7-15-83	Opinion for the Court filed by Circuit Judge Lumbard
7-15-83	Judgment entered that the Petition be denied, in accordance with the Opinion for the Court filed on this date

Chronology

Date	*Filings-Proceedings*
7-27-83	Intervenor's Bill of Costs filed
7-28-83	Respondents' Bill of Costs filed
8-22-83	Mandate issued
9-20-83	Order amending Opinion filed

Recommended Decision of Administrative Law Judge, dated November 12, 1982

UNITED STATES OF AMERICA

BEFORE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

November 12, 1982

DOCKET NO. R-0398

In the Matter of

APPLICATION BY BANKAMERICA CORPORATION

To Acquire

THE CHARLES SCHWAB CORPORATION

RECOMMENDED DECISION

Ernest G. Barnes
Administrative Law Judge

UNITED STATES OF AMERICA

BEFORE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

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IN THE MATTER OF
APPLICATION OF BANKAMERICA CORPORATION
TO ACQUIRE
THE CHARLES SCHWAB CORPORATION

Docket No. R-0398

Recommended Decision

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Recommended Decision

PRELIMINARY STATEMENT

On February 8, 1982, BankAmerica Corporation, San Francisco, California ("BAC"), applied pursuant to Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1843(c)(8)), and Sections 225.4(a) and (b)(2) of the Federal Reserve Board's Regulation Y (12 CFR §§ 225.4(a) and (b)(2)), for permission to acquire directly all of the voting shares of The Charles Schwab Corporation, San Francisco, California, and thereby indirectly acquire Charles Schwab & Company, Inc., San Francisco, California (together "Schwab").

The BAC application sought a determination by the Board that retail agency brokerage and the extension of margin credit were permissible activities for a nonbank subsidiary of a bank holding company (BAC Application at 3, 19-23). BAC also requested the Board to determine that several activities of Schwab, including account maintenance, payments of interest on net free balances, custodial services and its Kemper sweep arrangement, are incidental to brokerage and permissible activities under the Act (*Id.* at 13-14, 23-25).

By notice published in the *Federal Register* on April 14, 1982, the Board invited interested persons to express their views on whether: (1) the proposed activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto; (2) the proposed activities are permissible under the Glass-Steagall Act (i.e., 12 U.S.C. §§ 24, 78, 377 and 378(a)), which is designed to separate commercial from investment banking; and, (3) consumation [sic] of the proposal can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Parties requesting a hearing were directed to state why a written presentation would not suffice in lieu of a hearing, to

identify specifically any disputed question of fact, and to summarize the evidence that would be presented at a hearing.

Eighty-one comments were filed with the Board. Altogether, 64 commentors, including the Department of Justice, the Securities and Exchange Commission, and six federal reserve banks, supported the application. Among the 17 commentors who filed in opposition to the application was the Securities Industry Association ("SIA"), a national trade association of securities brokerage and investment banking firms, which on May 28, 1982, filed a memorandum urging that BAC's application be denied and requesting a formal hearing (SIA Opposing Memorandum at 48). SIA argued that the proposed activities had never been conducted by banks or bank holding companies to the extent proposed by BAC, and therefore may not be considered "closely related" to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. Additionally, SIA claimed that the proposed activities are precluded by Sections 16 and 20 of the Glass-Steagall Act. Finally, SIA disputed the public benefits alleged by BAC to accompany its proposal and claimed several possible adverse effects of permitting the merger, such as an undue concentration of resources, a lessening of competition among discount brokers, unfair competition due to Schwab's affiliation with a bank, voluntary tying and possible public confusion. In the event the Board chose to approve the acquisition SIA urged that conditions be placed upon the approval in order to minimize the risks involved (*Id.* at 41-42). By letter dated June 21, 1982, BAC opposed SIA's request for a hearing stating that no disputed material facts had been raised in connection with its proposal.

On July 6, 1982, the Board determined that while SIA's questions might appropriately be resolved through additional written submissions, a public and formal hearing conducted pursuant to an agreed-upon time schedule of the parties would provide an appropriate means to develop a full record for Board consideration of any disputed material fact involved in

BAC's proposal. The Board, accordingly, ordered such a hearing to commence September 13, 1982,[1] and established the following schedule (Order for Hearing at 4):

July 19, 1982	Production of Information response to the requests of the parties
August 18, 1982	Submission of Direct Testimony
September 13-17, 1982	Hearing
October 1, 1982	Submission of Briefs and Proposed Findings of Fact
October 12, 1982	Submission of Reply Briefs
November 12, 1982	Filing of Recommended Decision
November 24, 1982	Filing of Exceptions

With the consent of the parties, the Department of Justice was permitted to intervene in the proceeding (Prehearing Conference of August 5, 1982 at 10; Order Resulting From Prehearing Conferences of August 5, 1982 and August 19, 1982, dated August 20, 1982).

On July 7, 1982, BAC filed a request for production of documents from SIA; on July 12, 1982, SIA filed a request for production of documents from BAC and Schwab. An informal meeting among the parties and Board counsel was held on July 13, 1982, to discuss the scope of the respective production requests and establish procedures for confidential treatment of documents produced. By order of the Board dated July 19, 1982, a protective order to cover confidential documents produced in this matter was issued. Complete accord on either of the requests for production of documents was not reached, and SIA filed a memorandum dated July 16, 1982 that opposed

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1 This date was later moved forward, with the consent of the parties, to September 8, 1982.

BAC's discovery request; similarly, by letter dated August 2, 1982, counsel for BAC objected to SIA's proposed treatment under the protective order of documents produced and the relevance of certain of the documents. The differences relating to SIA's document requests were resolved by the parties (Order dated August 20, 1982). However, BAC and SIA were unable to resolve their differences as to the document request by BAC to SIA members. Therefore, it was determined that subpoenas *duces tecum* would issue at the request of BAC to the following SIA members: Merrill Lynch & Co., Inc., The E. F. Hutton Group, Inc., Dean Witter Reynolds Organization Inc., Bache Halsey Stuart Shields Incorporated, Paine Webber Incorporated, The Drexler [sic] Burnham Lambert Group Inc., and Shearson Loeb Rhodes, Inc. (*Ibid.*).[2] At a prehearing conference held on September 1, 1982, the subpoenas were substantially modified and as modified compliance was ordered (Prehearing Conference of September 1, at 3, 78). On September 9, 1982, five of the subpoenaed parties (excluding Shearson Loeb Rhodes, Inc.) filed with the Board a motion for permission to appeal the denial by the administrative law judge of a motion to quash the subpoenas. The parties subsequently resolved the subpoena controversy and BAC received and offered in the record affidavits by the SIA members in lieu of document production pursuant to the modified subpoenas (BAC Exhs. 82-87).

By order dated July 19, 1982, the undersigned administrative law judge was designated as the presiding officer in this matter. Prehearing conferences were held on August 5, August 19 and September 1, 1982. Two orders dated August 20, 1982 were issued rescheduling the hearing dates and disposing of other procedural matters. The hearing commenced at the Board's offices in Washington, D. C. on Wednesday, September 8, and concluded on Thursday, September 16, 1982. In all there were six days of hearings.

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2 Subpoenas *duces tecum* to the referenced companies were issued on August 19, 1982.

During the course of this proceeding written direct testimony was filed by 20 witnesses, nine of whom submitted written rebuttals and one written redirect. Over 130 exhibits were submitted by the parties, some of which were received under seal pursuant to a protective order dated July 19, 1982, issued by the Board. Eight witnesses were cross-examined in public hearings before the administrative law judge during the course of six days of trial. The transcript of record consists of 1,124 pages.

After having heard and observed the witnesses and after having carefully reviewed the entire record in this proceeding, including all written testimony and documentary evidence submitted by the parties together with all proposed findings of fact and conclusions of law and supporting memoranda, the administrative law judge makes the following findings of fact and conclusions and issues the Recommendation set out at the end hereof.

FINDINGS OF FACT

I. *Identification of Parties*

A. *The BankAmerica Corporation*

1. BAC was organized in 1968 and became the holding company of the Bank of America NT&SA (the "Bank") in 1969. Measured by assets, BAC is the second largest bank holding company in the United States (Prussia Direct at 2, 3).

2. The Bank is BAC's principal subsidiary (SIA Exhs. 1, 12). It is the largest bank in the United States and the dominant financial institution in California (Mussa Direct at 47-48; Mussa Rebuttal at 41; Mussa Tr. at 651-652). Other subsidiaries of BAC include FinanceAmerica Corporation, Decimus Corporation, and BA Mortgage and International Realty Co. (McLin Tr. at 27). These subsidiaries engage in a variety of activities throughout the United States, primarily consumer and commercial lending, mortgage banking, leasing,

data processing, investment advisory services, and certain credit-related insurance underwriting and insurance agency activities (Prussia Direct at 3).

3. At year-end 1981, BAC had total assets of $121,158 million, of which $112,325 million are assets of the Bank (Mussa Rebuttal at 28; SIA Exh. 1 at 4; SIA Exh. 2 at 2). BAC had net income of $445.4 million in 1981, down from $645 million in 1980 (SIA Exh. 1 at 7). The Bank's net income for 1981 accounted for 88.15% of the total net income of its parent, BAC (SIA Exh. 1 at 35; Mussa Direct at 7). At the end of 1981 BAC reported $4,091 million of equity capital, while the Bank's equity capital amounted to $4,048 million, or 98.9% of the equity capital of BAC (Mussa Direct at 7; SIA Exh. 1 at 4; SIA Exh. 2 at 2).

4. The Bank operates more than 1,100 branches throughout the State of California and engages in a full range of commercial banking activities. Over 3 million households in California are BAC customers. The Bank offers its customers various depository services, trust services, and a wide variety of real estate, consumer-related and commercial loans. Through its branches, loan production offices, and an Edge Act subsidiary, and through over 100 foreign branches and various foreign subsidiaries and affiliates, the Bank offers business customers a full range of domestic and international banking services throughout the United States and abroad (Prussia Direct at 3; SIA Exh. 7 at 5).

5. The Bank's 1981 California domestic deposits totalled $51,944 million, which represents 35.8% of all bank deposits in the State of California (SIA Exh. 37 at 111; Mussa Rebuttal at 30). When California savings and loan association deposits are added to bank deposits, the Bank's share of total deposits becomes 20.2% (Mussa Rebuttal at 32).

6. At the end of 1981 the Bank had 33.3% of total loans in domestic offices of California banks (SIA Exh. 37 at 6; Mussa Rebuttal at 30). In bank loans the Bank's percentages range

from 29.7% to 37.1%, depending on the category of loan (SIA Exh. 37 at 6; Mussa Rebuttal at 31).

B. *Charles Schwab & Co., Inc.*

7. Schwab was founded in California in 1971. It is a securities brokerage firm registered pursuant to Section 15 of the Securities Exchange Act of 1934 (Schwab Direct at 1-2). Schwab is qualified as a broker-dealer in all fifty states and the District of Columbia (Stupski Direct at 3). Schwab is a member of various securities exchanges. It has two seats on the New York Stock Exchange; one seat on the Chicago Board Options Exchange; two seats on the Pacific Stock Exchange; and is represented on the floors of other exchanges (Stupski Tr. at 96-98). Until June 1982, Schwab relied on Pershing & Co. to execute and clear its trades on the New York Stock Exchange, and Schwab still uses Pershing for its options trading (Stupski Direct at 3; Stupski Tr. at 66).

8. Schwab became a discount broker when all brokerage commissions were unfixed on May 1, 1975 and Schwab reduced its commissions for all transactions (Schwab Direct at 1-2). Schwab is the largest discount broker in the United States (Stupski Direct Exh. 1, 11; SIA Exh. 41 at 4; Mussa Rebuttal at 38-39). It has 51 offices in 26 states and the District of Columbia. Nine of its offices and its headquarters are in California. Schwab has recently opened a foreign office in Hong Kong (Schwab Direct at 5). Schwab currently has approximately 300,000 customers, virtually all of whom are individuals or small corporations (Schwab Direct at 4).

9. Most of Schwab's transactional business is conducted by telephone. Schwab maintains at least 80 toll-free numbers which enable its customers (and potential customers) to call it from all parts of the United States, either to obtain information about opening an account, or to conduct transactions once they have an account. An account can be opened entirely by mail. In response to telephone inquiries, Schwab sends out a

package of all the materials a customer needs to open an account, which the customer can fill out and return to Schwab. Schwab assigns no personal broker to a customer and makes no investment recommendations. Stupski Direct Exh. 1 contains a brochure that provides a general overview of Schwab's activities (Stupski Direct at 2-3; SIA Exh. 41 at 7).

10. In 1981, Schwab received over $29 million in commission revenues (Schwab Direct at 12). This represents approximately 9% of the commissions received by all discount brokers (SIA Exh. 41 at 4; SIA Exh. 7 at 4), but less than 1% of all retail securities brokerage commission revenues (Mussa Rebuttal at 39; BAC Application at 4). The bulk of Schwab's business is security transactions involving equity securities (Stupski Tr. at 96).

11. On June 30, 1982, Schwab had $125 million in assets, $12 million in shareholders' equity, and $9 million in net capital computed pursuant to the rules of the Securities and Exchange Commission under § 15 of the 1934 Act (Schwab Direct at 5-6). Schwab has experienced rapid growth in recent years. Between 1979 and 1981 its assets have doubled (SIA Exh. 41 at 4, 8). Over the past five years Schwab's commission revenues have grown at a compound rate of 70% and it [sic] revenues have grown at a compound rate of 77%. Over the past four years its pre-tax income has grown at a 90% compound rate (SIA Exh. 41 at 4). In its Iatest [sic] fiscal year, Schwab's return on average equity was nearly 30% (SIA Exh. 59 at 2).

12. Schwab buys and sells securities solely on the order and for the account of customers. It does not engage in market making or more than a minimal amount of dealing or underwriting, and it gives no investment advice. Incidental to its brokerage activity, Schwab extends margin loans to customers, offers custodial services, a self-directed IRA account, carries customer credit balances, on some of which it pays interest, and maintains an arrangement whereby customers may invest

temporarily free balances in an unaffiliated money market fund (BAC Application at 4; McLin Direct at 9; Stupski Tr. at 60). Schwab offers a wider range of services [sic] other discount brokers (Stupski Tr. at 115).

13. The only securities transactions in which Schwab engages that might be characterized as other than agency transactions are the "inadvertent principal" transactions that arise as a result of errors in executing customer orders and the "riskless principal" transactions in connection with the purchase and sale of new issue municipal bonds in Schwab's Munimart service (Stupski Direct at 13-15; Stupski Tr. at 95; *see also* F. 64, 65).

14. Employee compensation by Schwab is based, in part, on volume of business done in an individual office and Schwab's overall volume. There is no compensation for volume of sales by specific individuals (Stupski Direct at 18-19; Stupski Tr. at 90-92, 125).

15. Schwab's employee handbook states that the firm does not give advice or counsel people on investments. An employee who is found giving advice to customers could be terminated for cause (Stupski Tr. at 126).

C. *Securities Industry Association*

16. SIA is a national trade association representing over 540 organizations responsible for over 90% of the securities brokerage and investment banking business of the nation. SIA's membership is a cross-section of the securities business encompassing members of national securities exchanges as well as firms which are not members of such exchanges. The business of its members includes retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, and various exchange floor functions (SIA Opposing Memorandum at 1).

D. *Department of Justice*

17. The Department of Justice represents the interests of the United States Government. The Department was permitted to intervene after having filed comments with the Board as to the propriety of the acquisition. The Department has certain expertise in the area of unfair competition and it is therefore a proper party to this proceeding (Prehearing Conference of August 5, 1982, at 4-7; Order Resulting From Prehearing Conferences of August 5, 1982 and August 19, 1982, dated August 20, 1982).

E. *Federal Reserve Board*

18. Congress has conferred upon the Board of Governors of the Federal Reserve System the authority and the duty of determining "after due notice and opportunity for hearing" whether proposed acquisitions by bankholding [sic] companies are permissible under the Bank Holding Company Act (12 U.S.C. § 1843(c)(8)). The General Counsel's Office of the Board participated in this proceeding and has filed proposed findings of fact and supporting memoranda.

II. *The Brokerage Industry*

19. According to the SEC's staff report on the securities industry, as of 1980 there existed 2,444 broker-dealers whose securities-related activities brought them into contact with the investing public. New York Stock Exchange ("NYSE") members represent only 16% of total number of firms doing public business in 1980, but their revenues comprised 86% and their assets 92% of the industry's total (BAC Exh. 55 at 15 [SEC Staff Report on "The Securities Industry in 1980"]).

20. Revenues of the securities firms doing a public business reached $18.6 billion and pre-tax income increased to $2.7 billion in 1980. These figures represent 40.7% and 85.0% increases respectively over a profitable 1979. Securities commissions continued to be the most imported [sic] source of

revenues, accounting for 34.3% of total revenues. They increased by 41.3% to $6.4 billion in 1980, reflecting the 42.0% increase in the number of shares, rights and warrants traded on all exchanges and the 84.3% increase in NASDAQ volume (*Id.* at 15-16 [sic]).

21. Historically, securities commission income has been the mainstay of the industry, consistently supplying more revenues than any other source. But while revenues from commissions have increased by 75% since 1972, other revenue sources have taken on increased importance. Commission revenues comprised 35.5% of total revenues in 1980 compared to their 1972-1980 high of 55.3% in 1973. One factor in this decline was the elimination of fixed rates in 1975 and the ensuing decline in commission rates. Other factors include rising interest rates and diversification on the part of broker-dealers, which have contributed to the rapid growth of interest revenues and "all other revenues" (*Id.* at 20-21).

22. Revenues from margin financing reflect the level of interest rates, the volume of market activity, margin requirements and investor preference for leverage. A rapid increase in the volume of margin debt since 1975, in conjunction with the upward trend in interest rates, has led to an increase in margin interest income as a proportion of total revenues. This revenue source contributed 7.8% of total revenues in 1974, its 1972-1980 low, and 14.7% in 1979. With margin debt and interest rates both increasing, this revenue source grew in absolute terms in 1980, but declined as a proportion of total revenues (*Id.* at 21).

23. There has been a long-term trend toward consolidation within the securities industry. This consolidation initially took place as firms perceived the need to strengthen their financial structure and to create a more permanent capital base. This trend has intensified in recent years in response to firms' desires to diversify their operations in order to compete more sucessfully with other diversified financial companies, to stabi-

lize earnings, to enhance growth prospects, and to achieve operating advantages through economies of scale in such areas as data processing, communication, advertising and marketing. A corollary effect of such consolidation, however, has been an increasing concentration of industry revenues (*Id.* at 79).

24. The consolidation that has occurred has affected a wide spectrum of broker-dealers. For example, the relative size of the largest four firms increased from 18% to 24% of total revenues from 1971 to 1980. During this period, the fifth through the eighth largest firms grew from 7% to 13% of total revenues, while corresponding figures for the ninth through the sixteenth largest firms were 11% and 15%. Measuring firm size in terms of assets provides similar results. This suggests that increasing concentration in the securities industry is not the result of several large firms edging towards a strong oligopoly, but rather expansion, through consolidation or growth, of a number of firms attempting to achieve economies of scale, diversification, and an expanded capital base (*Id.* at 80).

25. The largest firms in the securities industry tend to conduct their business in many different geographic areas of the nation. Although their penetration of these geographic markets varies considerably, it is noteworthy that they face substantial competition from smaller firms (principally regional firms) in all of them. Thus, the securities industry appears to remain competitive in terms of structure, as well as conduct and performance (*Ibid*).

26. Since May 1, 1975, when fixed commission rates were eliminated, commission rates have generally decreased for institutional as well as individual investors. The two principal factors influencing the commission charge on a particular order are (1) the volume of commission revenues generated by the account and (2) the size of the order. Clients who do considerable business with a firm are sometimes able to negotiate rate reductions on brokerage transactions. Institutions

usually generate much more commission revenue per account than individuals and their rates reflect this. In addition, effecting transactions for a client on a regular basis may reduce brokerage costs. This explains, in part, the lower charges institutions pay for smaller transactions. Increasing order size leads to higher commissions, but as fixed costs are spread over a larger order, commissions increase less than order size and the commission rate declines (*Id.* at 82-83).

27. The behavior of commission rates since April 1975 differed considerably, depending on the client type or order size. Institutions experienced the most substantial reduction in rates. Rates were reduced across all transaction sizes, and while commission charges for larger orders declined at a more rapid rate, commission rates on even the smallest orders were substantially reduced. While commission rates for individuals also declined, this decrease was not as impressive as that for institutions and did not occur across all order sizes. The overall decline in commission rates for individuals was due to reductions in the commissions charged for large orders only, as well as an increase in the proportion of large orders. The rates charged on small orders have increased (*Ibid*).

28. Overall, commission rates remained virtually unchanged during 1980, with individuals experiencing a slight decline and institutions exhibiting mixed results. Commission rates both as a percent of principal value and per share declined for individuals while commission rates for institutions decreased as a percent of principal value and increased per share (*Id.* at 83).) [sic].

29. Prior to 1975, broker-dealers discounting commissions on brokerage transactions for retail customers were limited to offering discount commission rates on OTC transactions or operating as intermediary agents between clients and "third market" dealers. The elimination of fixed commission charges in May 1975 expanded opportunities for discount brokers considerably by making it possible for NYSE member firms to offer discount commission rates on transactions in NYSE-

listed stocks and by enabling brokers who were not NYSE members to negotiate access to the NYSE at lower rates (*Id.* at 85).

30. Discount brokers [sic] share of retail commission revenues has grown steadily from 3.5% in 1977 to 6.1% by the fourth quarter of 1980.[3] Commission revenues of these firms grew by 345% during this period, as compared to a 214% increase in retail commissions for all firms doing a public business. The surge in trading activity during 1980 benefitted discount brokers more than the industry in general. While retail commission revenues for the industry increased 40% from 1979 to 1980, that of discount brokers increased 74% (*Id.* at 86-87).

31. As the discount brokerage segment of the industry has matured, profitability has become more elusive for new firms. The discount broker-dealers established in 1977 and 1978 experienced a median of 1.75 and 1.0 unprofitable quarters, respectively, before their first profitable one. However, the firms established in 1979 required a median of 4.0 unprofitable quarters before their first profitable one. Nevertheless, the number of discount brokers continue [sic] to expand, attracted largely by the superior profits obtained by the more seasoned firms (*Id.* 87).

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3 Two assumptions were necessary to estimate the discount broker-dealers' share of commission revenues. First, these estimates assume that the industry has a retail/institutional commission revenue split equal to that of the firms reporting in the Commission's Survey of Commission Charges on Brokerage Transactions. This proportion varied from a low of 62% in the second quarter of 1980 to a high of 69% in the fourth quarter. A second assumption is that discount broker-dealers have only a retail business. It is possible that small institutions also may find commission rates at discount firms attractive if research and other aspects of the full-service package are unimportant to the institution. In this event, the commission share estimates of discount brokers would be somewhat overstated.

III. *Securities Activities Presently Conducted by Banks*

A. *In General*

32. On January 3, 1977, the Securities and Exchange Commission ("SEC") issued its "Initial Report On Bank Securities Activities" (BAC Exh. 53). This report stated:

> "Banks historically have played a major role in securities activities and the securities markets. While the permissible range of bank securities activities was circumscribed by passage of the Glass-Steagall Act in 1933, that Act did not separate the business of commerical banking from all aspects of the securities business. Banks act as underwriters of, and dealers in, U.S. government and municipal securities, manage the investments of others as trustee and agent, and are actively involved in the handling of securities and in the settlement of securities transactions for broker-dealers, institutional customers and others.
>
> "Although the Glass-Steagall Act placed restrictions on banks' dealings in corporate securities, the extent of their activity in purchasing corporate stock as agents for their customers has increased in recent years. In the years since 1968, a period of declining individual ownership of corporate securities, more than one million investors began using the services of banks to buy corporate securities. Banks also have shown a willingness to innovate in offering securities services. While some of the bank securities services described in this report have not been successful, others, such as dividend reinvestment plans, have been well received.
>
> "While bank securities services are comparable to and competitive with services offered by broker-dealers, banks are excluded from the definitions of 'broker' and 'dealer' in the Securities Exchange Act of 1934 (the 'Exchange Act'). Banks therefore are excluded from registration with, and regulation by, the Commission, with the result that securities regulations relating to execution and confir-

mation of transactions, the handling of customers' funds and securities, advertising and other activities do no [sic] apply equally to banks and broker-dealers offering similar services. The concern regarding these regulatory differences prompted this Study." (BAC Exh. 53 at 9)

33. On June 30, 1977 the "SEC" issued its "Final Report On Bank Securities Activities." This report was prepared at the direction of Congress as a study of the extent to which banks maintain accounts on behalf of public customers for buying and selling publicly-traded securities and whether the exclusion of banks from the Securities Exchange Act of 1934 definitions of "broker" and "dealer" is consistent with the protection of investors and the other purposes of that Act.[4] The bank securities activity studied by the SEC "falls generally into three categories: bank brokerage-type services, utilized primarily by individual investors; bank trust department securities trading activities, primarily for personal trust, personal agency and employee benefit accounts; and bank corporate financing services for corporations and other business organizations" ("Final Report On Bank Securities Activities, Pursuant To Section 11A(e) of the Securities Exchange Act of 1934," June 30, 1977, [BAC Exh. 54 at 1-2]). The SEC's report presented detailed analyses of four bank-sponsored securities services which are similar to services offered by broker-dealers: dividend reinvestment plans, employee stock purchase plans, automatic customer purchase plans and customer transactions service. The report further stated:

"The common element of the bank securities services studied is that banks providing the services, like brokers,

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4 Section 3(a)(4) of the Securities Exchange Act defines the term "broker" as follows:

The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. 15 U.S.C. § 78c(a)(4) (1970).

are engaged in effecting transactions in securities for the account of others . . . . [footnote omitted] In considering the continued advisability of the Exchange Act exclusions for banks, the Commission's primary focus has been upon the protection of investors using these services. This has involved an analysis of the manner in which specific bank securities activities are conducted, recognizing that in some respects bank services are functionally equivalent to those of broker-dealers, while in other respects they are not." (BAC Exh. 54 at 3).

34. Four brokerage services have been provided by banks: (1) Customer Transaction Services ("CTS"); (2) Dividend Reinvestment Plans ("DRP"); (3) Employee Stock Purchase Plans ("ESPP"); and (4) Automatic Investment Services ("AIS"). The estimated market value of the transactions represented by these four types of services as a percentage of all transactions on national stock exchanges is 0.9% (BAC Exh. 53 at 10-11, 13; Mussa Direct at 26; SIA Exh. 45 at 6-7).

35. Customer Transaction Services are the most flexible of bank investment plans, allowing customers to place orders to buy or sell virtually any stock. After accepting a customer's order, the bank transmits the order to a broker-dealer for execution and handles the clearance and settlement of the transaction. The SEC's "Initial Report on Bank Securities Activities" concluded that as of 1976, more than 4,300 commercial banks (30% of banks) offered CTSs (BAC Exh. 53 at 4, 13, 85-86; Mussa Direct at 26-27). Banks have traditionally offered CTSs as an accommodation to their customers who have accounts with the banks. They are usually provided on an informal basis and are not advertised. Viewed alone, they are not profitable; nevertheless, the services are offered by more banks than all other formal services combined (BAC Exh. 53 at 86).

36. Dividend Reinvestment Plans provide an opportunity for shareholders to reinvest dividends received on their shares.

Many DRPs also provide shareholders the option of investing other funds in the purchase of additional stock. Banks administer DRPs by holding shares for the account of the participants and acquiring additional shares in the market or, in some instances, through direct purchases of stock from the issuer. DRPs were first offered by banks in 1968, and as of 1977, 68 banks (0.5% of all banks) administered such plans for 727 companies. An estimated 1,900,000 individuals have participated in these plans (Drew Direct at 1-2; Jacobs Direct at 10; BAC Exh. 53 at 13, 15).

37. Employee Stock Purchase Plans provide employees of an issuer an opportunity to invest a predetermined amount in the stock of their employer through voluntary periodic payroll deductions. Banks administer these plans by holding the shares for the account of the participants and acquiring the necessary shares in the market or, in some instances, through direct purchases from the issuer. The first ESPP was offered by a bank in 1953; as of 1977, 59 banks (0.4% of all banks) provided such services (Jacobs Direct at 10; BAC Exh. 53 at 13, 36-37).

38. Automatic Investment Plans provide participants the opportunity periodically to invest predetermined amounts in equity securities selected by them from a list compiled by the administering bank. Banks administer these plans by holding the shares for the account of the participants and purchasing the necessary shares in the market. AIPs were first introduced in mid-1973. By purchasing large numbers of shares at one time, the bank was able to pass substantial savings in transactions on to individual purchasers. Since the unfixing of brokerage commissions in 1975, AIPs have not been profitable and have been discontinued by most banks that offered them. As of 1977, 18 banks (0.1% of all banks) provided the service (Jacobs Direct at 11; BAC Exh. 53 at 13, 54-59; Mussa Tr. at 595).

39. A large proportion of bank securities transaction activities are provided by bank trust departments. These securities activities are comparable to and competitive with many services offered by broker dealers. Bank trust departments offer services to a wide variety of customers, including individual trusts and estates, pension funds, and profit sharing and other benefit plan funds. Services provided to bank trust department customers include the holding of securities for their accounts, investment advice, and the arrangement for the purchase and sale of securities. Bank trust departments maintain custody of the securities, collect dividends and credit them to an interest-bearing account. The bank may or may not offer investment advice to the customer (i.e., the owner or others responsible for investment decisions for the account). In any event, the bank, acting as agent, executes the investment instructions of the customer and purchases and sells securities for the account accordingly (Ireland Direct at 1, 5; Mussa Tr. at 1008; BAC Exh. 54 at 135-43). These activities are in many respects the functional equivalent of those performed by retail brokerage firms (Ireland Direct at 2, 5; Jacobs Direct at 11-12). As the SEC's "Final Report on Bank Securities Activities" (June 30, 1977) stated:

> ". . . with respect to the purchase and sale of securities for their managed accounts, bank trust departments are performing in many respects the same activities as are performed by retail brokerage firms. They are effecting transactions in securities for the account of others. Like brokers, trust departments are intermediaries (as agents or trustees) between their clients' accounts and third persons with whom they effect securities transactions. While in a majority of cases bank trust departments do not deal directly with such third persons, but rather hire a broker to make that connection, that fact differentiates them from brokers only by degree: for example, forwarding or "corresponding" brokers effect transactions by going to another broker to consummate an execution. In addition,

to a significant degree banks effect securities transactions without using brokers at all. For example, in a significant minority of cases trust departments negotiate directly with dealers to effect transactions. In some cases they effect transactions directly with other institutions or entirely in-house by crossing orders between two or more accounts. . . ." (BAC Exh. 54 at 121-122).

40. While in a majority of cases bank trust departments employ a broker for some role in most of their securities transactions, the SEC has found that ". . . in a significant minority of cases trust departments negotiate directly with dealers to effect transactions. In some cases they effect transactions directly with other institutions or entirely in-house by crossing orders between two or more accounts." (BAC Exh. 54 at 122; *see also* Ireland Direct at 2-5). In transactions involving large orders of listed securities (as well as transactions involving the crossing of buy and sell orders of bank customers), trust department trading desks are actively involved in arranging the transaction, and often use a broker only to perform the formal execution (Ireland Direct at 2-5; BAC Exh. 54 at 173-75).

41. Banks are permitted to underwrite and deal in obligations of the United States and its agencies, general obligations of states and municipalities, and certain limited types of municipal revenue bonds. Banks are active participants in the markets for such securities (Wiatrak Direct at 2-10; Baxter Direct at 12-13), and have been very important as underwriters and dealers of municipal securities for institutional investors (Mussa Tr. at 599). Banks also engage extensively in money market instruments such as negotiable certificates of deposit and bankers [sic] acceptances (Baxter Direct at 7-20; Biller Tr. at 235, 237; Jacobs Direct at 7-13; Jannotta Rebuttal at 11-16; Mussa Direct at 26-29; BAC Exh. 53 at 9).

42. Recently, a large number of banks have begun to provide expanded brokerage services to their customers pursuant

to contractual arrangements with securities brokerage firms, including discount brokerage firms (Baxter Direct at 11, n.1; Biller Direct at 18-20; Biller Tr. at 253; Jacobs Direct at 13). Security Pacific National Bank recently entered into an arrangement with Fidelity Brokerage Services in Boston to provide discount brokerage services through Security Pacific's more than 600 branches. A number of other banks also have arrangements with Fidelity to provide securities transactions at discount rates. Chemical Bank recently entered into an arrangement with Donaldson, Lufkin & Jenrette to provide stock and bond brokerage services, margin loans, and other financial services in the New York Metropolitan area. Citibank has entered into a joint venture with Quick & Reilly, Inc. to provide brokerage services to that bank's customers (Baxter Direct at 11; Biller Direct at 19, 37; Jacobs Direct at 13).

43. The Comptroller of the Currency and the FDIC have generally affirmed the recent tendency of banks to get more involved in discount brokerage operations (*see, FDIC Statement of Policy on the Applicability of the Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Non-Member Banks*, September 1, 1982; *Security Pacific National Bank*, Comptroller of the Currency slip op. at 4-5, August 26, 1982; and *Union Planters National Bank of Memphis*, Comptroller of the Currency Opinion, September 20, 1982).

44. In offering securities transaction services, banks engage in the same activities as brokers. They maintain customer accounts, receive orders from customers, arrange for the execution of those orders or in some instances perform the execution themselves, provide confirmation of the transaction, and keep track of all the records associated with the customer's account (Baxter Direct at 13-14; Baxter Tr. at 433, 491-92; Biller Tr. at 364-65; Jacobs Direct at 9). Banks also employ many of the same securities brokerage procedures that brokers use. For example, in connection with both customer and trust department securities transactions, banks rely on the same

tools as brokers do (*e.g.*, the Quotron, NASDAQ, and other terminals) to select the appropriate market (Grady Direct at 2-4; Ireland Direct at 2-5; Wiatrak Direct at 5; Wiatrak Tr. at 206). In connection with trades involving large orders of both listed and unlisted securities, bank trust departments employ the same techniques for selecting the best market and trading strategies that brokers use (Ireland Direct at 3-5; BAC Exh. 54 at 173-75).

45. Many securities transactions, such as over-the-counter trades, are not conducted on an exchange but with a market maker (Biller Direct at 9; Biller Tr. at 314-15, 360; Jannotta Rebuttal at 4-5, 8-9; Stupski Direct at 2-4). In connection with such transactions off the exchange, banks and brokers execute and clear securities transactions in the same manner (Biller Direct at 12; Biller Tr. at 360-61).

46. While banks have traditionally relied upon brokers to execute listed equity transactions, many brokers, such as "introducing brokers," are not members of exchanges and therefore rely on third parties to execute their transactions involving listed securities, just as banks may do (Biller Direct at 12; Biller Tr. at 239, 243; Evanskass Direct at 1; Drew Direct at 3; Stupski Direct at 3; BAC Exh. 54 at 121-122). Until June 1982, Schwab relied on Pershing & Co. to execute and clear its trades on the New York Stock Exchange, and Schwab still uses Pershing for its options trading (Stupski Direct at 3; Stupski Tr. at 66). Third party correspondent brokers, such as Pershing, offer the same execution and clearing services to both banks and brokerage firms (Stupski Tr. at 110). Pershing is in the business of being a broker's broker and executes transactions as a correspondent broker for over 125 clients, including a number of banks. Fidelity, Schwab's largest discount brokerage competitor, uses Pershing for its NYSE trades (Stupski Direct at 3). Also, brokers that are members of exchanges frequently rely on third parties to execute their transactions just as banks do (Biller Direct at 9; Jannotta Rebuttal at 4-5; Stupski Direct at 3-4; BAC Exhs. 80-83).

47. Banks have traditionally offered margin credit to their customers, pursuant to Regulation U of the Federal Reserve Board. Regulation U, which limits the amounts that banks may lend on stocks, has been in effect since 1936. As of the end of 1981, commercial banks had approximately $5 billion in loans outstanding to purchase or carry securities by borrowers other than brokers, securities dealers or other financial institutions (Baxter Direct at 12). Margin lending by brokers is governed by Regulation T of the Federal Reserve Board. The fundamental activity in broker margin lending—making secured loans to individual customers—is functionally equivalent to bank margin lending, as well as, more generally, the numerous other types of secured lending that banks perform (Baxter Direct at 11-12; Baxter Tr. at 491; Biller Direct at 11, 13; Jacobs Direct at 14; Stupski Direct at 4-5; 12 CFR §§ 220, 221). Margin lending is a major activity for Schwab. Forty-five percent of all trades executed by Schwab are conducted in margin accounts (Stupski Direct at 2-3).

48. Custodial services for securities and other items have traditionally been extensively provided by banks (Ireland Direct at 1; Wiatrak Direct at 5; BAC Exh. 11 at 6; BAC Exh. 53 at 77). Virtually all brokers offer custodial services whereby customers' securities are registered in street name and held in a depository on behalf of the customer. An "introducing broker," which does not itself carry customer accounts or offer custodial services, does so indirectly through its correspondent firm (Biller Direct at 13; Biller Tr. at 319; Jannotta Rebuttal at 4-5, 10-11; Mussa Rebuttal at 12; Stupski Direct at 5; Stupski Tr. at 58; BAC Exh. 79 at ¶ 5; BAC Exh. 80 at ¶ 3; BAC Exh. 81 at ¶ 3; BAC Exh. 82 at ¶ 3, BAC Exh. 83 at ¶ 3). Custodial services are required in connection with margin accounts (Biller Direct at 13; Stupski Direct at 5; Stupski Tr. at 58, 60). Cash account securities certificates may be held by the customer, but approximately 35 percent of Schwab's cash account customers elect to use its custodial services. Taking Schwab's margin and

cash accounts together, approximately 50 percent of all Schwab accounts that are opened involve use of Schwab's custodial services. Securities custodial services are a necessary adjunct to Schwab's brokerage business (Stupski Direct at 5).

49. Many banks offer IRA accounts to their customers (Biller Direct at 13). Some brokerage firms, including Schwab, offer their customers self-directed IRA accounts that allow the customer to contribute annually a set amount of tax-deferred funds, which can be used for different forms of investment (Schwab Direct at 5; Biller Direct at 13; Stupski Direct at 6; Stupski Tr. at 57-58; McLin Direct at 9).

B. *Bank of America's Securities Activities*

50. Bank of American [sic] has historically engaged in a variety of securities transactions services, including trust department services, CTSs and DRPs. In addition, the Bank has been significantly involved in retail transactions with respect to municipal securities, U.S. Government and agency securities, and money market instruments (McLin Tr. at 5-6; Wiatrak Direct at 4-5, 8; Wiatrak Tr. at 189-96, 200-01, 206-08).

51. The Bank's trust department is involved in securities trading for a variety of accounts including agency accounts, personal trusts, court trusts, pension funds (including retirement, stock investment, and profit sharing plans), and the common trust funds managed by the trust department for the investment of assets held by the Bank as trustee. Instructions for trades come either from a district trust administrator (where the power to engage in transactions is held by the maker of the trust or some other person), or from a portfolio manager (where the bank has investment power as trustee) (Ireland Direct at 2).

52. Bank of America's trust department is extensively engaged in securities transactions services. In 1981, the total trust department trading volume for equity securities was approximately $2 billion and for municipal securities was

approximately $151 million (Alcock Direct at 1; Ireland Direct at 2). The total trust department trading volume for fixed income securities during the first half of 1982 was approximately $8 billion (Grady Direct at 4). The Bank's trust assets in 1981 totaled approximately $10 billion for all agency and trust and estate accounts over which the bank had investment discretion (Mussa Tr. at 1005-08).

53. The bulk of the Bank's trust department trading in listed securities utilizes the services of a securities brokerage firm at some stage of the transaction. If buy and sell orders are equal in size and coincide in timing, they may have the opportunity to cross trade and will do so at a price equal to the last sale if the market information available indicates that such a price would be fair. In order to document the price to both trust accounts involved, the bank normally engages a broker to execute the offsetting transactions on an exchange. The brokerage commission involved in such trades is smaller than usual. On occasion the bank has purchased stock directly from the customer-sellers; in such cases establishing the price requires special documentation (Ireland Direct at 3).

54. The Bank provides securities transaction services (CTSs) in which the Bank acts as agent in filling orders for customers (primarily individuals) for the purchase and sale of corporate stocks and bonds. In 1981, the Bank's activity in this connection involved 6,526 trades having a dollar value of $37,512,000. In 1982 (through May) there were 2,508 trades having a dollar value of $10,144,000 (Evenskaas Direct at 1-2).

55. The Bank administers DRPs for BAC and 16 other companies. Six of the plans are original issue plans in which the Bank, acting as agent, purchases stock directly from the issuing company. The rest are market purchase plans. In 1981, DRPs administered by the Bank involved market purchases of 451,808 shares having a total dollar value of $10,689,541 and market sales of 175,894 shares having a total dollar value of $3,690,593 (Drew Direct at 1, 4-5). The Bank utilizes a broker in connection with these activities (Drew Direct at 3).

56. In 1981 the Bank engaged in 29,993 transactions in municipal securities, reflecting a total dollar value of $25 billion, an average of $800,000 per trade (Wiatrak Direct at 2; Wiatrak Tr. at 195-198). In 1981 the Bank had 52,103 trades in U.S. Government and U.S. agency securities reflecting a total dollar volume of over $130 billion (Wiatrak Direct at 6). Most of the business involving municipal securities, U.S. Government and agency securities, and money market instruments is institutional; however, the Bank is also significantly involved in retail transactions with respect to such securities. BAC employs 35-40 employees for retail activities involving these securities and actively solicits individual customers for municipal securities (Wiatrak Tr. at 190-91, 206-07). Between 50 to 60 percent of the Bank's total number of transactions in municipal securities involve individuals (Wiatrak Tr. at 207), and 10 to 15 percent of the dollar volume of trades of municipal securities, U.S. Government and agency securities, and bankers' acceptances are retail transactions (Wiatrak Tr. at 190, 194, 196). Applying these percentages to the Bank's total annual volume of sales in municipal securities, U.S. Government and agency securities, and bankers' acceptances, the Bank's annual volume of sales to individuals in these securities is approximately $3 billion, $16 billion, and $1.4 billion, respectively (Wiatrak Direct at 2, 6, 8-9; Wiatrak Tr. at 200-01).

C. *Other Financial Activities By Banks And Brokers*

57. During recent years as the impact of inflation has increased the cost of having idle funds that do not earn a return and consumers have become increasingly sensitive to the cost of leaving funds underutilized, brokerage firms have begun to make available to these customers a return on the cash balances in the customers' accounts (Biller Direct at 14-16; Stupski Direct at 6-7; Stupski Tr. at 115-18). Virtually all brokers of any significant size offer their customers some mechanism through which they can earn a return on the available funds in their accounts pending further investment

(Biller Direct at 14-17; Biller Tr. at 319-20; Stupski Direct at 6-13; BAC Exh. 79 at ¶ 8-9; BAC Exh. 80 at ¶ 7; BAC Exh. 81 at ¶ 7; BAC Exh. 82 at ¶ 7; BAC Exh. 83 at ¶ 7).[5] The provision of means for customers to earn a return has become a virtual necessity for effective competition in the brokerage business on any significant scale (Stupski Direct at 6-7; Stupski Tr. at 101-02, 115-18; *see also* Biller Direct at 14-17; Biller Tr. at 369; Mussa Tr. at 1012; BAC Exh. 79 at ¶ 8-9; BAC Exh. 80 at ¶ 7; BAC Exh. 81 at ¶ 7; BAC Exh. 82 at ¶ 7; BAC Exh. 83 at ¶ 7). The provision of an opportunity to earn a return on available funds through an account arrangement is comparable to certain aspects of banking.

58. One method by which many brokerage firms, as well as banks and savings and loan associations, provide for a return on funds in customer' [sic] accounts is through "sweep accounts." Sweep accounts are money market funds that link existing security brokerage accounts and/or bank accounts to productive investments. Essentially, amounts above a specified minimum are regularly "swept" out of a customer's account with a bank or brokerage firm and into a money market fund, where it earns a higher rate of return. At present a number of brokers and depository institutions offer retail "sweeps" in conjunction with independent money market fund management companies, such as Fidelity, Federated, Kemper, or Dreyfus. Banks offering such "sweep" accounts include Chase and Bank of New York. Federated now claims to be offering this service to more than one hundred banks (Biller Direct at 15-20; Jacobs Tr. at 548, 563-64; Stupski Direct at 8-9; Biller Tr. at 319-20).

59. In addition to offering "sweep" arrangements, some brokers, including Schwab, also pay interest directly on tem-

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5 As of March 18, 1981, thirty-four money market mutual funds operated by brokers or dealers accounted for 60% of the $104.5 billion in assets of 110 such funds. (Reported in *Donoghue's Money Fund Report*, and cited in the SEC's staff report on "The Securities Industry in 1980" at 79).

porarily idle funds in their customers' accounts (Stupski Direct at 9-10; BAC Exh. 81 at ¶ 3; *Security Pacific National Bank*, Comptroller of the Currency slip op. at 16, August 26, 1982). The direct payment of interest on customer cash balances by brokerage firms by definition and practice is functionally equivalent to the payment of interest by banks on accounts such as savings acounts (BAC Exh. 11 at 65).

60. Cash management accounts are another means by which brokerage firms service their customers. It is a hybrid account, offering a number of financial services. Its main features usually include (1) the opportunity to earn interest on net free balances in a brokerage account, through either a money market fund functioning as a "sweep" account or the direct payment of interest, (2) a mechanism by which the customer can more readily redeem his funds, whether by check or by debit card, (3) the use of margin accounts to secure borrowing against eligible securities, (4) automatic features that tend to maximize returns received, through the establishment of a hierarchy of investments and redemptions (such that withdrawals are made from the least remunerative funds and investments are made to the highest yield funds), and (5) integrated monthly statements showing all account activity and balances (Biller Direct at 15-16).

61. Banks have been participants in the provision of cash management accounts since their initiation. Crocker Bank of San Francisco has its Working Capital Accounts and Citibank of New York has a similar program. Bank One of Columbus, Ohio, serves Merrill Lynch, Dean Witter, and Bache (Biller Direct at 17-18). Brokerage firms, including Schwab through its Schwab One Account, offer their customers cash management accounts. Providers of such accounts include Merrill Lynch (Cash Management Account), and Bache Halsey Stuart (Command Account). (Biller Direct at 15-20; Biller Tr. at 248-51, 319-20; Stupski Direct at 10-12; Stupski Tr. at 76; BAC Exh. 79 at ¶¶ 8-9; BAC Exh. 80 at ¶ 7; BAC Exh. 81 at ¶ 7; BAC Exh. 82 at ¶ 7; BAC Exh. 83 at ¶ 7).

62. The Schwab One Account arrangement was introduced in November 1981. It offers a variety of financial services, including the maintenance of an account at Schwab for securities transactions, the payment by Schwab of interest on net free balances, check-writing privileges, a VISA debit card with a one-percent discount for purchases, and a comprehensive monthly statement of all activity in the account (Stupski Direct at 10-11 [Stupski Exh. 6]; Stupski Tr. at 76-83). The interest rate offered by Schwab, which currently is based on the 13-week Treasury bill rate, is lower than the rates that could be obtained through various other interest-earning investment opportunities, such as money market funds (Stupski Direct at 11; Stupski Tr. at 79).

63. The treatment of free credit balances in a customer's account is governed by a number of applicable regulations. New York Stock Exchange Rule 436, SEC Release 34-18262 (1981), as well as the Securities Investors Protection Act, strictly limit the manner in which interest-bearing accounts may be offered and maintained. Rule 15c 3-3 under the Securities Exchange Act of 1934 limits the uses to which customer balances can be put (Stupski Tr. at 81). Schwab has recently adopted a policy of sending a written reminder every six months to all account holders who have not conducted any trades in the previous six months, informing them that they should only keep in their Schwab One Account funds that are "awaiting investment" (Stupski Direct at 11; Stupski Tr. at 80-83).

D. *Schwab's Inadvertent Principal Transactions, Munimart Service, and Money Market Fund Activity*

64. "Inadvertent principal" transactions occur when Schwab makes a mistake in purchasing securities on behalf of a customer and must maintain (and then liquidate) the unwanted shares for its own account. Principal positions that arise as a result of errors are an unavoidable incident to the ordinary conduct of any agency securities transaction business and

typically create a loss (Stupski Direct at 13-14). Inadvertent principal positions arise in well below 1 percent of all of Schwab's trades, and therefore constitute a miniscule portion of Schwab's business (Stupski Direct at 14).

65. Schwab's Munimart service, which Schwab introduced in July 1982, offers customers the opportunity to purchase and sell municipal bonds through Schwab. It involves two types of transactions: (1) secondary market transactions in which Schwab arranges for the purchase and sale of municipal bonds that have already been issued, and (2) new issue transactions in which Schwab arranges for the purchase of new municipal bond offerings (Stupski Direct at 15). In secondary market transactions, Schwab acts as agent for its customers in the same way it now does in transactions involving unlisted (over-the-counter) securities—*i.e.*, securities that are not traded on an exchange. In such transactions, the broker must seek out the dealer selling (or purchasing) the securities covered by the customer's order (Stupski Direct at 15-16; Stupski Tr. at 123-24). In transactions involving new municipal bond issues, Schwab purchases the municipal securities from the underwriting syndicate offering the bonds, but only if it has a firm customer purchase order for that security on hand prior to its acquisition of the bond. It then immediately resells the bonds to its customer at the public offer price (Mussa Direct at 42; Stupski Direct at 16-18). Schwab's revenues from its Munimart service, including both secondary market transactions and new issue transactions, constitute less than 0.2 percent of its entire revenues. Most of these transactions involve the secondary market. In the first month and a half after the Munimart service began operations, Schwab only engaged in two new issue transactions (Stupski Direct at 18; Stupski Tr. at 95).

66. Schwab offers a "sweep" arrangement in conjunction with the Kemper Cash Equivalent Fund (the "Fund"), a money market fund that is advised and administered by Kemper Financial Services, Inc. ("Kemper") (Stupski Direct at 7). Schwab acts only as an agent for its customers in dealing with

the Fund. It arranges for the purchase of shares in the Fund on behalf of the customers, processes the transfer of payments between the Fund and the customers' accounts, and generates periodic records for its customers reflecting their investment in the Fund. Schwab does not purchase shares in the Fund for its own account for resale to its customers. Schwab receives no remuneration from its customers for these services it performs. The Fund maintains on its books the names of the Schwab customers holding an investment with the Fund and transmits all proxy materials directly to them (Stupski Direct at 7-8). Under its agreement with Kemper, Schwab receives compensation from Kemper calculated on a sliding scale ranging from 35 basis points to 25 basis points *per annum* of different amounts in the Fund. Schwab is compensated for its *pro rata* share of the entire amount in the Fund, based on the shares its customers hold in the Fund pursuant to Schwab's agreement with Kemper. For the fiscal year ending September 30, 1981, Schwab's payments from Kemper constituted less than 1 percent of Schwab's revenues (Stupski Direct at 9; Stupski Rebuttal at 3-4).

IV. *Public Benefits Resulting From the Acquisition*

A. *Increased Awareness of Discount Brokerage Firms Will Lead to Lower Costs for Consumers*

67. Between April of 1975, the last month before the unfixing of brokerage commission rates, and December 1981, institutional commission rates (cents per share) decreased by 66.5%; rates for individual investors decreased by only 33.3%. Commission rates as a percent of principal value declined 57.1% for institutions and 22.07% for individuals. The decline in rates charged individuals was due to reductions in charges for large orders and an increased percentage of large orders. In 1981 individual investors experienced an overall decline in commission rates with respect to large and small orders. However, commissions charged individuals for small order transactions involving fewer than 1000 shares are presently

greater on a per share basis than under the fixed rates (BAC Exh. 52 at 2, 6-10 [SEC Report on "Commission Rate Trends 1975-1981"]).

68. There are two basic types of brokerage firms, generally referred to as full-line brokers and discount brokers (SIA Exhs. 7, 10; Biller Tr. at 253-255). "Full-line" brokerage firms are firms that typically offer the widest range of customer services (solicitation of orders and investment research and advice) and, generally, charge a single price covering both execution and advice. "Discount" brokers are brokers who charge commissions below prevailing rates. Discount brokers tend to offer fewer services and to emphasize price and execution. They often do not offer investment advice (Baxter Direct at 26; Baxter Tr. at 437-38; Biller Direct at 23; Biller Tr. 254-255, 335; Stupski Tr. at 61-63; BAC Exhs. 79-83). Discount brokerage firms in general and Schwab in particular have commission rates that are generally below those offered by brokerage firms prior to May of 1975. Discount brokerage firms also have commission rates that are below the rates charged by full-line brokerage firms (BAC Application at 8; BAC-Biller Exh. 13 [Discount Brokerage Firm Advertisements]). There are a number of discount brokerage firms that charge commissions [sic] rates that are lower than Schwab's (Mendelson Rebuttal at 6; Stupski Tr. at 61-62; SIA Exh. 40). As of the fourth quarter of 1980, discount brokerage firms' commission revenues constituted only 6.1% of total commission revenues received by all brokers (BAC Exh. 55 at 102 [SEC Staff Report "The Securities Industry" 1980]; *see* F. 30).

69. Full-line firms do give discounts to some of their customers, but they normally decline to disclose their policies on discounts or even the normal commission rates they charge (Biller Direct at 28; Biller Tr. at 323, 356; Jacobs Direct at 21-22; Jacobs Tr. at 552-53, 554j-54k; Stupski Tr. at 104; BAC Exh. 32 at 29; BAC Exh. 80 at ¶ 6; BAC Exh. 81 at ¶ 6; BAC Exh. 82 at ¶ 6; BAC 83 Exh. at ¶ 6; *see* F. 27). Institutional

customers, such as banks and insurance companies, are large and significant customers of brokerage services. They could and did ask for and receive competitive price quotations. After May 1, 1975, when fixed commissions were eliminated for retail brokerage business, the then-existing full-line firms generally did not lower their commission rates on retail business, and they have continued to compete almost exclusively on the basis of service. (Biller Direct at 22, 27-28; Ireland Direct at 3; BAC Exh. 39 at 17-18; BAC Exh. 55 at 98; BAC Exh. 74 at 361, 424-25; BAC Exh. 52 at 2, 6-10 [SEC Report on "Commission Trend Rates 1975-1981"]).

70. A wide variety of publications and investment advisory services are available at reasonable costs to investors who choose not to rely on full-line brokers for advice or investment research (Biller Direct at 22; Schwab Direct at 6). Customers of full-line firms who trade on the basis of their own research or research obtained from sources other than their broker, and customers who use full-line brokers for unsolicited orders, could in general use discount brokers to achieve identical services and pay lower commission rates (Biller Direct at 22, 26; Schwab Direct at 6-7). Discount brokerage firms are presently in direct competition with full-line brokers for some of these customers, as evidenced by discount brokerage advertisements which compare full-line prices and discount prices (BAC Biller Exh. 13 [Advertisements of Discount Brokerage Firms]). There is evidence that there is a substantial overlap between the customers of discount brokerage firms and full-line brokerage firms (SIA Proposed Finding 94).

71. According to the testimony of BAC witnesses, many potential customers of discount brokers do not yet use such brokers because discounters are relatively new and not well-established in the marketplace (Biller Direct at 30-31; Biller Tr. at 327-28; Jacobs Direct at 19-20; Jacobs Tr. at 569-70; McLin Direct at 10; Mussa Tr. at 927; Schwab Direct at 7-8; Stupski Tr. at 104; *see also* F. 30). There also is some evidence in the

record that the public distrusts discount brokerage firms (BAC Biller Exh. 14, *Confidential*). Affiliation with BAC would associate Schwab with a well-known and reputable financial organization and would make Schwab more visible to potential customers (SIA Brief at 83-84).

72. Full-line brokerage firms take the activities of discount brokers into account in determining their prices and how they will compete. By making Schwab a more effective competitor, the acquisition will tend to elicit competitive responses from other brokers, including both full-line firms and discount brokers (Baxter Direct at 19; Baxter Tr. at 483; Biller Direct at 32, 34-35; Jacobs Direct at 22; BAC Exhs. 79-83). In response to increased and more effective competition from Schwab and other discount brokers, full-line firms would be more likely to compete on the basis of price and to "unbundle" their services (*i.e.*, allow brokerage customers to purchase execution services separately from advice). Insofar as full-line brokers respond to additional competition by unbundling their services or more vigorously competing on the basis of price, investors will benefit by being able to choose from among a greater number of suppliers of a wider variety of packages of services, and from increased price competition (Schwab Direct at 9; Baxter Tr. at 439-40, 454-459, 460, 483; Baxter Direct at 15-18; Biller Direct at 27-28, 30-37; Biller Tr. at 374; Jacobs Direct at 17-23; Jacobs Tr. at 549-51; Mussa Tr. at 895-96; BAC Exh. 74; BAC Exh. 32 at 32).

73. BAC's acquisition of Schwab will help make Schwab a more effective competitor by providing Schwab with capital for office expansion, technical innovation, and other purposes, and by providing Schwab with additional management and technological resources (Baxter Direct at 18-20; Biller Direct at 29-34; Biller Tr. at 371-72; Jacobs Direct at 18-22, 27-29; Jacobs Tr. at 554-54h, 565-66; McLin Direct at 10-11; McLin Tr. at 19; Mussa Rebuttal at 21, 27-28; Prussia Direct at 8-9; Schwab Direct at 6-8; Stupski Tr. at 72; Wiatrak Tr. at 214).

Schwab's past innovations include creation of an "on line" system of customer accounts (which reduces paperwork and allows the registered representative to confirm securities trades by computer), and extensive use of automated execution services offered by various exchanges (Schwab Direct at 10-13; Biller Direct at 29). Capital assistance from BAC will help Schwab remain a leader in embracing new technologies that enable brokers to cut costs, reduce error rates, and provide better service (Baxter Tr. at 460-61; Biller Direct at 29-34; Jacobs Direct at 27-29; Jacobs Tr. at 554d-54g; McLin Direct at 11; Prussia Direct at 8; Schwab Direct at 10-13; Stupski Tr. at 72). Insofar as the acquisition enhances Schwab's development and use of new technologies, these will increase competition in the securities brokerage business and will help to spread such new technologies throughout the industry (Biller Direct at 32-35; Jacobs Direct at 27-29; Schwab Direct at 12-13).

74. Competition among all financial institutions has increased and has focused on providing consumers with attractive packages of financial services that cut across traditional industry lines (Biller Direct at 14-20; Jacobs Direct at 26-27; Jacobs Tr. at 544-45; McLin Tr. at 9-10; Prussia Direct at 4-5; *see also* Findings 57-63). Many brokerage firms are now offering packages of financial services to their customers, including asset management accounts that combine traditional brokerage accounts, margin lending, check writing privileges, use of a credit or debit card, and "sweep" or other transaction features that help to assure that maximum rates of return are earned on free cash balances. These packages of financial services are competitive with services offered by banks (Biller Direct at 14-20; Jacobs Direct at 15-16; 26-27; BAC Exh. 51; *see also* Findings 57-63). Since BAC's announcement of its planned acquisition of Schwab, numerous banks have announced plans to provide discount brokerage services either directly or through joint venture programs (Baxter Direct at 11; Baxter Tr. at 463-65; McLin Direct at 7; *see also* F. 43). BAC's development of financial service offerings with Schwab

will spur competition between banks and between banks and other financial service firms to provide attractive packages of financial services (Biller Direct at 32-35; Biller Tr. 320-21; McLin Direct at 11; Prussia Direct at 7-8; Jacobs Direct at 22-23; Jacobs Tr. at 544-48). By allowing BAC to compete more vigorously in the emerging "financial services" industry, the acquisition will result in increased competition among all financial services firms (Baxter Direct at 19; Baxter Tr. at 463-66, 481; Biller Tr. at 320; Jacobs Direct at 22-23, 26-27; McLin Direct at 2-3, 6; Prussia Direct at 3-5, 7, 10-11).

B. *Increased Convenience*

75. The acquisition will provide Bank customers with convenient brokerage services and Schwab customers with convenient banking services (Baxter Tr. at 460-62; Jacobs Tr. at 553; McLin Direct at 8; McLin Tr. at 36; Prussia Direct at 7; Wiatrak Tr. at 214). The acquisition will enable Schwab to make its services conveniently available through Bank offices in California (and potentially through FinanceAmerica offices outside the state) (Baxter Direct at 21; Baxter Tr. at 433; Biller Direct at 31-32; Biller Tr. at 339-40; McLin Tr. at 19, 34-36). Bank already has instituted a test program to provide access to Schwab's services (including account forms, a quotation machine, and a certificate depository) by means of kiosks in several Bank branches (Biller Tr. at 370-71; Jacobs Tr. at 554; McLin Direct at 8-9; McLin Rebuttal at 1-5; McLin Tr. at 15-17, 30, 36-37). BAC has anticipated that it will add several thousand new Bank customers from Schwab customers through cross selling of services (*see* F. 103).

C. *Increased Efficiencies*

76. The potential for "complementary" and/or increased efficiencies exists with respect to banking and brokerage services (Baxter Direct at 17-18; Baxter Tr. at 433-34; Becker Rebuttal at 7-10; Wiatrak Tr. at 214). The acquisition will allow BAC and Schwab to share management resources

(Jacobs Direct at 19-21; McLin Direct at 11). It will allow BAC and Schwab to share marketing resources (Baxter Direct at 19; Biller Direct at 31-32; Jacobs Direct at 19-20; McLin Tr. at 34, 40), and computer resources (Biller Direct at 33-35; McLin Tr. at 19, 35). The acquisition will allow Schwab to increase the efficiency with which it obtains capital funds, since BAC will more readily be able to ascertain Schwab's needs, and the appropriate cost of funds, than could unaffiliated providers of funds (Becker Rebuttal at 4; Mussa Tr. at 788). Insofar as potential customers select Schwab or BAC services on grounds of convenience, this will result in increased efficiencies because fewer resources will be used to produce the same goods (Baxter Rebuttal at 1-2; Becker Rebuttal at 7-8).

77. BAC's acquisition of Schwab will be more efficient than expansion of the Bank's existing activities since the latter would require the accumulation of new management resources and computer software, and substantial time (Baxter Tr. at 480-81; McLin Direct at 5; McLin Tr. at 7-9, 11, 13-14; Prussia Direct at 6). BAC's acquisition of Schwab will make it possible for Schwab to compete more effectively immediately and will avoid substantial delay in the time in which increased competitive pressures can be brought to bear upon full-line brokers in the retail brokerage market (Baxter Tr. at 479-81; Jacobs Direct at 425; McLin Tr. at 9, 11). BAC's acquisition of Schwab will be a more efficient way for it to expand in the retail brokerage industry than by joint venture since the BAC/Schwab product development can be permanent and tailored to new offerings BAC believes will be most attractive and not limited to accepting the services offered by individual joint venture contractors (Baxter Tr. at 466; McLin Direct at 6; Mussa Tr. at 722).

D. *Increased Financial Support*

78. The acquisition will allow Schwab to increase the amount of capital funds available for growth and investment in new technology since BAC will be able to supply the firm with money at a lower marginal rate than Schwab would

obtain on its own (Mussa Direct 6-7, 11-18). In 1980, Schwab had to abandon an attempt to access the capital market because of a lack of public response (BAC Application at 31).

79. The securities brokerage industry's earnings are volatile due to relatively high fixed costs and widely fluctuating earnings caused by wide variations in trading volumes (Mendelson Direct at 11-14; Mendelson Rebuttal at 8-9). BAC's capital resources will be able to provide Schwab with more financial stability during times of stress (*see* SIA Proposed Findings 365-367, 369-370).

E. *Synergistic Effect of the Acquisition*

80. Affiliation with BAC will give Schwab access to broader management and technical resources. BAC has experience in many areas as yet untouched by Schwab. For example, BAC has large-scale foreign operations, an arena of great growth potential that Schwab has recently entered by opening a Hong Kong office (Prussia Direct at 9; Baxter Direct at 21). Schwab will also be able to draw on BAC's advanced technical skills in the area of data processing (Schwab Direct at 12-13).

81. BAC and Schwab both have excess data processing capacities. Due to the fact that they have different demand cycles for computer time, by joint utilization of facilities the firms can reduce excess capacity making more efficient use of a single combined system (McLin Tr. at 19, 35; Biller Direct at 33-35).

V. *Possible Adverse Effects of the Acquisition*

A. *Schwab's Competition in the Municipal Bond Market*

82. The Bank serves as an underwriter of certain general obligation municipal bonds, and it maintains a trading inventory of $135 million of such securities which are bought or sold from time to time in large block transactions. The Bank is the predominant bank underwriter and dealer in municipal bonds

in California (Mussa Tr. 921). Municipal bonds are not traded on exchanges and must be purchased (or sold) through dealers who carry such bonds (Stupski Rebuttal at 2).

83. Under the Munimart arrangement, developed after the announcement of BAC's proposed acquisition of Schwab, Schwab carries out orders for municipal bonds for its customers by obtaining a quote from the Bank on the desired bond or a similar bond in the Bank's inventory. If the Bank does not possess the precise bond requested by Schwab's customer, then the Bank will offer quotes on similar bonds in its inventory, which quote the Schwab employee will pass on to the customer. If the customer agrees to make the purchase after learning of the bond's availability, Schwab will buy the bond from the Bank's bond department for immediate resale to the customer (SIA Exh. 17 at 2; Mussa Direct at 41-42). In only about half the bond transactions it carries out do Schwab customers specify the particular bond desired (Stupski Tr. 122-23).

84. The Munimart arrangement between BAC and Schwab presents an opportunity for the Bank to sell some municipal securities to Schwab customers that it might not otherwise sell through its underwritings (Mussa Direct at 44). Since the inception of the Munimart arrangement, approximately 80% of Schwab's municipal bond transactions have been conducted through the Bank; in about 50% of the transactions the bank acts out of its own inventory, and in the remaining 30% the bank acts as an agent finding a buyer to purchase a bond Schwab's customer is selling (Stupski Rebuttal at 4).

85. Banks have a special tax privilege allowing them to deduct the entire carrying costs for their inventories of municipal bonds in determining their federal tax liabilities (Mussa Direct at 42; Wiatrak Tr. 231; Mussa Tr. 1013). The Internatl [sic] Revenue Service does not permit broker-dealers who hold inventories of tax-exempt municipal bonds to deduct interest paid on that fraction of their debt that is assigned to the

carrying of municipal bonds (Mussa Tr. at 1013). Therefore, commercial banks that operate as traders of municipal bonds have a significant tax advantage relative to securities dealers that trade the securities (Mussa Direct at 43). The Bank would realize this tax advantage on the bonds out of innventory [sic] which are sold through the Munimart arrangement with Schwab.

86. Bank holds in inventory municipal bonds which it sells to other brokers and dealers at the same price at which it sells to Schwab. The Bank and other dealer banks and broker/dealers advertise in the blue list the bonds in their inventory which they wish to sell through the same, nationwide medium (Darby Rebuttal at 1; Stupski Tr. at 85-86; Mussa Tr. at 849-51). Other brokerage firms are able to carry out buy and sell orders for municipal bonds from their customers in conjunction with commercial banks (Becker Rebuttal at 11). In such case there is no reason to believe that Schwab will receive any artificial advantage as compared to other firms that buy municipal bonds from the inventories of the Bank, dealer banks, and broker/dealers (Becker Rebuttal at 11-12).

B. *Capital Costs for Bank Subsidiaries*

87. It is a common practice for parent companies to provide money to their subsidiaries in the form of equity capital and loans in order to meet the funding requirements of the subsidiaries (Mussa Tr. at 942; Biller Tr. at 342-45; S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955)). An acquired company which is funded by its parent may experience lower funding costs after the acquisition for several reasons, including the strengthening of the subsidiaries' economic potential and lessening of its risk as part of a larger enterprise, and on account of efficiencies with respect to transaction costs and evaluation of the risks which the subsidiary faces (Becker Rebuttal at 2-4; Mussa Tr. at 786-88, 946; Prussia Direct at 8-9).

88. Commercial banks and other depository institutions enjoy advantages over other types of firms in their costs of

securing capital when such funds are obtained from depositors (Mussa Direct at 6-7). Federal deposit insurance agencies provide an absolute guarantee against losses by depositors in insured institutuions [sic] for deposits up to $100,000 (Mussa Direct at 5; Mussa Tr. 780-81). Government agencies such as the federal Rrserve [sic] banks provide protection to holders of large uninsured deposits by loaning money to commercial banks to enable such depositors to withdraw their deposits when a bank is experiencing financial difficulty (Mussa Direct at 5). The commercial bank advantage in obtaining these funds is attributable to government-provided explicit and implicit guarantees that deposits will be insulated wholly or partially from losses (Mussa Direct at 6; Mussa Tr. 978).

89. Banking laws restrict lending by a bank to its parent holding company and to that holding company's non-banking subsidiaries so severely as to make such lending impracticable. Thus, BAC, not the Bank, is the source of funding for its non-banking subsidiaries (Prussia Direct at 10). BAC will be able to provide capital to Schwab in a manner more efficient and at lower cost than the alternatives available to Schwab were it to enter the capital markets directly (Prussia Direct at 8; Mussa Direct at 12-14).

90. Under the policies in force with respect to funding by BAC of its wholly-owned non-bank subsidiaries, a non-bank subsidiary must identify the uses to which borrowed funds are put and on that basis the rate charged is either the long-term rate or the short-term rate. The short-term rate is a compilation of the monthly average yields on 90-day commercial paper of ten A-1, P-1 rated companies, to which is added 0.125 percent per annum for handling and 0.138 percent per annum to cover the cost to BAC of the commitment fees on its standby lines of credit. The resulting rate closely reflects the actual cost of short-term funds to BAC, which obtains such short-term funds principally through the issue of commercial paper (Terry Direct at 2; SIA Exh. 6). A1 is the top rating for

commercial paper by Moody's; P1 is the top rating for commercial paper by Standard and Poor's (Mussa Tr. 948).

91. A more complex market rate is used by BAC to charge non-bank subsidiaries for long-term funds. That market rate reflects the fact that long-term funds are raised over time, at varying intervals and at varying interest rates. Each month the average yield on secondary market one-year certificates of deposit issued by prime banks is taken from available market information sources. The resulting rate is adjusted for the additional cost of reserves and federal deposit insurance and for differences in the frequency of the payment of interest. Because the market for CDs with maturities in excess of one year does not have sufficient depth to give consistent, reliable market rates relevant to the Bank's and BAC's cost of longer-term funds, a maturity premium or discount is added, based on the differences in yields on one-year and five-year U.S. Treasury obligations. This rate closely reflects the cost of acquiring five-year funds by the Bank and by BAC during the relevant month. For the actual interest charges for long-term funds, it is assumed that the funds supplied by BAC and used by the subsidiary were acquired in equal monthly amounts over the preceding 60 months and a "composite" or "pool" rate for such funds is then calculated (Terry Direct at 3-4).

92. The charges to BAC's subsidiaries are designed to and do reasonably approximate BAC's own cost of funds (Terry Direct at 2-4). BAC would have no incentive to provide funds to Schwab unless it could expect to receive a return equal to the marginal cost to it of making these funds available, including an appropriate return for the risk incurred (Becker Rebuttal at 3-4, 12; McLin Tr. at 24-26; Prussia Direct at 8).

93. The equity capital of the Bank dominates the financial statements of its holding company (Mussa Direct at 7; *see also* F. 3); therefore, the cost of capital to BAC is largely determined by creditors' assessments of the risks of the Bank (Mussa Direct at 7-8; Mussa Tr. at 776, 980-81). Those who control institutions which have lendable funds are aware that

government agencies will not allow a large commercial bank to fail. Hence, those institutions are willing to lend funds to large commercial banks on more attractive terms than they would be willing to lend to other types of businesses (Mussa Direct at 5-7). However, bank holding companies in general do not raise money at lower rates than other large firms. In fact, bank holding companies incur somewhat higher marginal costs for short, medium, and long-term funds as compared to large industrial and non-bank related financial firms (Kimmell Rebuttal at 4).

94. The testimony and affidavits of officials of BAC, Merrill Lynch and Bache Halsey Stuart (a brokerage subsidiary of Prudential), show that the commercial paper rates of BAC were, if anything, slightly higher than the commercial paper rates of Merrill Lynch, Sears, and Prudential for the period May through July of 1982 (Cush Rebuttal at 2 [Cush Exh. 1]; BAC Exh. 84 [Merrill Lynch letters]; BAC Exh. 85 [Bache letter]). Statistics published by the Federal Reserve Board indicate that BAC's commercial paper rates during the period May through July 1982 were generally the same or higher than both the rates on commercial paper placed for other firms whose bond rating is AA or the equivalent and the rates on commercial paper of firms which placed their commercial paper directly (*Compare* Federal Reserve Statistical Release Forms H.15 (519) for May through July 1982 *with* Cush Exh. 1). Similarly, the Forms 10-K of Merrill Lynch and American Expreess [sic] and the Annual Report of Sears show that the weighted average interest cost of their commercial paper in 1979, 1980, and 1981 were comparable to the cost experienced by BAC:

	1979	*1980*	*1981*
Sears	11.03	13.05	16.36
Merrill Lynch	11.01	13.30	16.21
American Express	11.06	13.16	15.88
BAC	11.27	12.58	16.34

BAC Exh. 1 at 30-31; BAC Exh. 61, 62; BAC Exh. 63 at S-9.

C. *Effect of Acquisition of Schwab on BAC's Banking Position in California*

95. There are 308 banks in California, thirteen have resources in excess of $1 billion and five have resources in excess of $10 billion (Mussa Tr. at 740). Bank of America is the largest bank in California; it had domestic deposits of $51,944 million in 1981, or 35.8% of all bank deposits in the State of California (SIA Exh. 37 at 111; Mussa Direct at 47-48; Mussa Rebuttal at 30, 41; F. 5). The bank's largest competitors in the California banking market are Security Pacific, Wells Fargo, Crocker National, and First Interstate (Mussa Tr. 740). As of 1981, Security Pacific has 12.3% of California bank deposits state-wide ($17,917 million), Wells Fargo had 9.8% ($14,200 million), Crocker National had 8.3% ($12,065.7 million) and First Interstate had 7.6% ($11,036.6 million) (SIA Exh. 37 at 111). As of December 31, 1981, the five largest California banks accounted for over 74% of all domestic deposits (4-firm concentration = 66%) and 76% of all domestic loans (4-firm concentration = 68%) in California banks (SIA Exh. 37; Mussa Rebuttal at 30-31).

96. Recent developments in financial services have significantly eroded the uniqueness of the products that commercial banks can offer so that banking concentration does not fully reflect the alternative sources available to the public for all the different banking services in a local market. The inclusion of non-bank depository institutions (savings banks and savings and loan associations) and other types of financial institutions, including those outside California but competing in the state, would dilute the market power of local commercial banks (Schweitzer Rebuttal at 5). When California savings and loan association deposits are added to bank deposits, the Bank's share of total deposits becomes 20.2% (Mussa Rebuttal at 32).

97. A number of separate and distinct products and services are offered by commercial banks. These include, *inter alia*, demand, time, and savings deposits; mortgage loans; consumer

loans; and business loans (Mussa Tr. at 614-22). In offering each of these financial services, California commercial banks compete to some extent not only with other California commercial banks, but also with out-of-state commercial banks, with foreign banks, and with many nonbank financial institutions (Baxter Tr. at 443-51). For example, in offering deposit services, California commercial banks compete with savings and loan associations and credit unions in California and with money market funds available nationwide (Baxter Tr. at 443-46; Mussa Tr. at 615, 622; BAC Exh. 71). In making mortgage loans, California commercial banks compete with savings and loan associations, mortgage bankers, insurance companies, and a variety of other lenders located both inside and outside of California (Mussa Tr. at 619, 907-08, 910-11; BAC Exh. 71). In making consumer loans, California commercial banks compete with savings and loan associations, finance companies, credit unions, retail merchants, and a variety of other lenders in California, as well as with banks and other institutions located outside of California (Baxter Direct at 23-24; Baxter Tr. at 477; Mussa Tr. at 620-21; BAC Exh. 71). In making business loans, California commercial banks compete with out-of-state bank loan production offices, savings and loan associations, finance companies, insurance companies, money market funds and other institutional purchasers of commercial paper, and a variety of other lenders (Baxter Direct at 23-24; Mussa Tr. at 615-22, 908-14). The majority of competition in national and international markets is for corporate business, [sic] the retail business is primarily a locally limited business (Baxter Tr. at 447).

98. According to a consumer survey prepared for Bank of America, the Bank's share of all loans to California consumers is approximately 9%. This study reflects loans and deposits by credit unions, finance companies, and other financial institutions in addition to banks and savings and loan associations (BAC Exh. 71). The Bank's share of all California consumer deposits held by banks, savings and loan associations, credit

unions, and other financial institutions is approximately 16 percent (BAC Exh. 71).

99. The Herfindahl Index is a measure of concentration used by economists for evaluating the competitive structure of a market. The Herfindahl Index for any market is the sum of the squares of the market share of all of the firms in that market. (The Index for a market with 100 equal size firms, each with a market share of 1 percent, would be 100. The Index for a market with a single firm with a 100 percent market shares would be 10,000.)

100. The Herfindahl index for bank deposits by Standard Metropolitan Statistical Areas ("SMSAs") in California range from 1400 to 2070 (Mussa Tr. 624-25, 1018), and the Index for bank deposits state-wide is 1680, (SIA Exh. 63; Mussa Tr. 624-25, 1017-18).

101. The following chart, which is set forth in the record as SIA Exhibit 62 (*see also* Mussa Tr. 1015-1019), indicates the Bank's share of deposits, and the Herfindahl index for bank deposits in California by SMSA. This data was calculated from FDIC data submitted by BAC (BAC Exh. 72) and from data collected by the Bank (SIA Exh. 37).

SMSA Code	*SMSA Name*	*Total Deposits (millions)*	*B of A Share*	*HI(1)*
0360	Anaheim	8,313	23.5	990
0680	Bakersfield	1,529	42.2	2310
1620	Chico	577	45.3	2610
2840	Fresno	2,086	47.7	2620
4480	Los Angeles(2)	46,593	24.7	1430
5170	Modesto	1,174	26.6	1400
6000	Ventura	1,586	30.5	1750
6690	Redding	442	43.3	2430
6780	Riverside San Bernadino	4,616	33.8	2270
6920	Sacramento	4,357	37.5	2090

SMSA Code	SMSA Name	Total Deposits (millions)	B of A Share	HI(1)
7120	Monterey Salinas	1,082	32.9	2410
7320	San Diego	6,444	28.6	1410
7360	San Francisco(2) Bay Area	44,078	51.0	3020
7400	San Jose	5,517	34.4	1830
7480	Santa Barbara	1,318	23.5	1380
7485	Santa Cruz	813	26.0	2740
7500	Santa Rosa	1,273	34.5	2060
8120	Stockton	1,819	31.3	1790
8720	Napa-Fairfield	1,101	45.8	2580
8780	Tolare	853	37.0	2300
9340	Yuba City	391	43.6	2890

(1) Herfindahl Index = sum of shares squared.

(2) Includes large CDs of major banks.

102. Using the data in the record in BAC Exh. 72 and BAC Exh. 73 and other documents, it is possible to derive market shares for a universe of deposits held by commercial banks and savings and loan associations in each of the SMSAs in California, and to approximate Herfindahl Indices sufficient for the purposes of this proceeding by using the data in Schweitzer Appendix C, squaring the market shares of the five largest firms in each SMSA, and estimating the maximum possible contribution to the Herfindahl Index from the market shares of the fifth through tenth largest firms. In applying the foregoing methodology to the San Francisco SMSA, approximately $13.2 billion in non-local deposits of Bank of America and approximately $1.2 billion in non-local deposits of State Savings and Loan in the Stockton SMSA should be excluded to avoid distorting the data (Hanna Redirect; Mussa Tr. at 1018; Wiatrak Tr. at 220-21; BAC Exh. 78). Further, Schweitzer Appendix C does not accurately represent the deposit shares of banks and savings and loan associations in the Visalia and

Yuba City SMSAs because it does not contain savings and loan association data for those areas. Based on the share data contained in BAC Exh. 72 and BAC Exh. 73, market shares and Herfindahl Indices for those two SMSAs can be calculated. The Herfindahl Indices and shares of the largest firms in market universes calculated on the basis of deposit data for banks and savings and loan associations in each SMSA in California pursuant to the methodology described above are approximately:

SMSA	*Herfindahl*	*Percentage Share of the Largest Firm*
Anaheim	450	12.5
Santa Barbara	575	12.5
Oxnard	600	15
Los Angeles	625	14
San Diego	775	16
Riverside	800	17
Modesto	850	18
San Jose	850	20
San Rosa	900	18.5
Sacramento	950	24
San Francisco	975	21.5
Stockton	1075	21
Vallejo	1075	27.5
Visalia	1100	24.5
Salinas	1150	18.5
Bakersfield	1200	27.5
Fresno	1250	28
Santa Cruz	1375	21
Yuba City	1575	30

103. An explicit rationale of BAC for the proposed acquisition of Schwab is its desire to expand the Bank's customer base (SIA Exhs. 7, 8, 9, 14; Mussa Rebuttal at 18). It is hoped that present Schwab customers in California will move their banking deposits to the Bank thereby increasing its deposit base

(SIA Exh. 8; McLin Tr. at 46). BAC estimates, and SIA agrees, it may reasonably expect to acquire 15,000 California customers from its association with Schwab. With an estimated gain in deposits of $10,000 per new customer, an overall increase in Bank deposits of $150 million can be anticipated, which represents an overall gain of approximately three tenths of one percent of the Bank's total deposits (Mussa Tr. at 749, 967-68; BAC Exh. 71; SIA Exh. 37).

D. *Voluntary Tie-In*

104. Section 106 of the Bank Holding Company Act, 12 U.S.C. § 1971-78, makes illegal any action by a bank to require a customer to purchase some additional service from the bank in order to receive an extension of credit. The Board has extended this prohibition to bank holding companies through Regulation Y, 12 CFR § 225.4(c)(1). Besides the overt requirement of the purchase of an unwanted product with a desired product, tie-ins may result from implicit coercion when, in view of a firm's market power, a customer purchases two products, one of which is unwanted (*see* H.R. Rep. No. 91-1747, 91st Cong., 2d Sess.; 1970 U.S. Code Cong. & Ad. News 5561, 5564).

105. Joint purchases—that is, purchasing two different goods or services from the same supplier at the same time—occur frequently in most product markets. In fact, millions of joint purchases occur because the potential search costs for the second good or service often exceed the potential savings for the customer from splitting the joint purchase into separate transactions. In other situations, the customer hopes that by making a joint purchase, a long-term business relationship is formed or furthered, which at some future date will become an advantage. The joint purchase made by the customer entirely voluntarily in his best interest cannot be considered a tied sale. In case the customer, in his or her best interest, voluntarily decides that the purchase of several goods or services from a single supplier will yield the most satisfactory purchase, a

voluntary joint purchase has occurred. It is also quite clear that a supplier may explicitly demand that anyone buying a product or service also purchase another service as a condition of supplying the first one. This latter type of coercive tying is illegal under Section 106 of the Bank Holding Company Act (Schweitzer Rebuttal at 1-2).

106. Between the two extremes of explicitly coercive tied sales and purely voluntary joint purchases, a wide variety of tied sale [sic] may occur. They may range from a situation that is characterized by strong "implicit" pressure by the supplier on the customer to make the tied purchase, to a mere suggestion of the seller to the buyer that it might be to his advantage to make the joint purchase. The degree to which these pressures are exerted successfully, or are correctly perceived by the buyer, depends importantly on the market power of the supplier (Schwwitzer [sic] Rebuttal at 2). Whenever an appreciable degree of implicit pressure exists, a joint purchase is no longer purely voluntary because a consumer's decision is influenced or constrained to some extent by the presence of market power in the tying market. On the other hand, a consumer may choose to buy more than one product or service from the same source on the assumption that as a regular customer he will receive a more personal service or some benefit in the future. To prohibit truly voluntary joint purchases would clearly diminish public benefits and would be contrary to the public interest. To force the purchaser to choose their second best alternative would deprive the public of their maximum satisfaction and potential search savings (Schweitzer Rebuttal at 1-2).

107. In the case of banking, the tying product is bank credit. Recent developments in financial services have significantly eroded the uniqueness of the products that commercial banks can offer so that banking concentration does not fully reflect the alternative sources available to the public for all the different banking services in a local market. The inclusion of savings and loan companies and savings banks and other types

of local financial institutions and those outside the area but competing in it, would dilute any market power of local commercial banks. Many alternative bank and non-bank sources of credit exist for locally limited customers (small businesses and consumers) that few borrowers could objectively conclude that any potential coercion or potential retribution exists if the two purchases are made separately. In competitive markets it is far more likely that borrowers judge the joint purchase to be both more convenient and more economical, resulting in some cases in a high proportion of joint purchases (Schweitzer Rebuttal at 5).

108. One of the most important objectives of the Bank's marketing program is the cross-selling of its services to present and prospective Schwab customers (Mendelson Direct at 2-3; Mussa Direct at 29-33; SIA Exh. 11 at 1). As testified to by BAC's Chairman, '[A] substantial effort will be made to offer Bank customers Schwab products and Schwab customers Bank products" (Prussia Direct at 7-9). According to an expert witness for SIA, customers of the Bank may open accounts with Schwab in anticipation of making loan applications to the Bank, especially if the customers believe that they are only marginally qualified to receive the loans (Mendelson Direct at 6; Mendelson Tr. 1057, 1074). BAC, in fact, anticipates that it will gain a substantial number of Schwab customers as Bank customers (*see* F. 103).

109. BAC's Anti-Trust Compliance Manual permits the Bank and BAC's nonbanking subsidiaries to take into account "present and/or past satisfactory relationships" with a customer when selling or pricing a loan (Mendelson Direct at 4; SIA Exh. 19 at 6). However, the manual specifically cautions Bank employees not to create an impression that customers can enhance the likelihood of obtaining services from the Bank by purchasing products which they do not desire from the Bank or its affiliates (BAC Exh. 10 at 7).

110. Cross selling is beneficial to consumers because it (1) lowers consumer search costs; (2) lowers the cost (and thus the price) of goods and services as a result of efficiencies of joint production and sale, and (3) increases the value of goods and services as a result of economies of joint purchase and consumption (Mussa Tr. at 811-12; Schweitzer Rebuttal at 1-2; BAC Exhs. 79-83 [Affidavits of Shearson, E. F. Hutton, Paine Webber, Merrill Lynch, and Bache Halsey]). BAC and its subsidiaries attempt to find cross selling opportunities as a way of lowering their costs and increasing the value of the services they provide (Prussia Direct at 4, 7-8). Securities brokerage firms, particularly full-line brokerage firms, also engage extensively in cross selling. They regard it as important to offer their customers "a variety of financial services and products, including those of its affiliates which offer opportunities for cross selling" (BAC Exh. 82 [Affidavit of Merrill Lynch] at ¶ 8; *see also* BAC Exhs. 79-81, 83; Mussa Tr. at 728-29, 811, 843-44; Prussia Direct at 3-5; Biller Direct at 14; Jacobs Direct at 26-27). To the extent that BAC's acquisition of Schwab results in cross selling packages of financial services to Schwab and Bank customers, the result will be added competition.

E. *Conflicts of Interest*

111. A bank owes a duty to its depositors to evaluate a loan application solely on the basis of whether the loan would provide an adequate rate of return in light of the repayment risk and whether the possibility of default is excessive (Mendelson Direct at 6). When a loan applicant is a customer or potential customer of an affiliated subsidiary, the parent will have an interest in insuring that the customer obtains the loan in order to retain or increase the business of the affiliate and maximize the profitability of the company's subsidiaries as a whole (Mendelson Direct at 7). Thus, a potential conflict of interest exists between the Bank's duty to its depositors and its desire to maximize the profitability of its parent corporation.

112. Schwab performs brokerage services of a type which the Bank uses as a fiduciary of trust accounts (Mendelson Direct at 8). The Bank has an obligation to the beneficiaries of trust accounts it administers to obtain for their accounts the best brokerage services at the lowest possible cost (Mendelson Direct at 8). The Bank will have an incentive to process its trust department securities transactions through Schwab in order to ensure that Schwab has a large order flow and thus meets its high fixed costs (SIA Exh. 34 at 183; Mendelson Direct at 8; Mendelson Tr. at 1092). The Bank's use of Schwab to process its trust account securities transactions would constitute self-dealing to the extent the Bank did not pay the lowest available price for the type and quality of brokerage services necessary (Mendelson Tr. at 1093). The fiduciary duty owed the Bank's trust account customers and BAC's economic interest in using Schwab to process the trust account orders constitutes a potential conflict of interest resulting from the acquisition (Mendelson Direct at 8-9).

113. Soundness of banking practices is a primary purpose of regulatory supervision of banks (Baxter Direct at 43). The Bank employs strict internal standards and safeguards to prevent unsound loans (Jacobs Direct at 37; Johnson Direct at 2-5). The loans made by the Bank are subject to periodic review by federal examiners (Baxter Direct at 44 n. 1; Prussia Direct at 10). The organizational structure and procedures of the Bank provide strong incentives to avoid unsound loans. Branch managers are evaluated on the basis of the performance of their branch, and the loan portfolio of each branch is subject to periodic review by the credit examination arm of the Bank's controller (Jacobs Direct at 38; Prussia Direct at 10). There is no evidence of any compensation or incentive structure that would give branch managers of the Bank an incentive to increase the number of Bank customers using Schwab services (Mendelson Tr. at 1050-51). The Bank's standard procedures do not call for loan officers to obtain information

about an applicant's use of the services of non-bank affiliates, although such association may be revealed in the application papers (Prussia Direct at 10; BAC Exh. 12).

114. Federal laws and regulations impose a duty on the Bank to choose brokerage services upon the basis of "best execution." Trust departments are closely examined by federal regulators and Schwab, in addition, is regulated by the rules and regulations of the SEC and the various exchanges (*see* 12 U.S.C. §§ 371c, and 12 CFR § 9.5; Mendelson Direct at 8; Biller Direct at 40). In addition, Bank would be subject to suit for failure of its fiduciary responsibilities. BAC has established procedures for its trust department to insure that it fulfils its fiduciary responsibilities (Ireland Direct at 2-5). There is no record evidence that BAC has, or will, engage in conflicts of interest that will cause undue consumer harm.

115. Members of SIA (including their affiliates) sometimes have multiple interests in dealing with a customer. To the extent that such multiple interests give rise to potential conflicts of interests, these customers are protected both by law and by internal controls of these firms. SIA members regard applicable legal requirements as sufficient to protect their customers' interests (BAC Exh. 80 at ¶ 8; BAC Exh. 81 at ¶ 8; BAC Exh. 82 at ¶ 10; BAC Exh. 83 at ¶ 10). There is no evidence that the acquisition of Schwab by BAC would give rise to any conflicts of interest different in character or magnitude from those which broker/dealers and their affiliates experience.

F. *Public Confusion*

116. BAC plans to use the logo "A BankAmerica Financial Services Company" in its promotional materials to describe Schwab (BAC App. at 57; Mendelson Direct at 9). BAC intends to establish a separate division of Schwab called "Bank Brokerage Services" and to place Schwab kiosks in Bank brances [sic] (Mendelson Direct at 10). BAC also plans to put Schwab officers on the premises of certain of BAC's Finance-

America offices (McLin Tr. at 34-35). The Bank and Schwab have begun a program allowing Bank's customers to use a Bank checking account or savings account as a payment mechanism for a Schwab brokerage account (Mussa Direct at 33; McLin Tr. at 30; McLin Rebuttal at 3; SIA Exh. 13 at 205-212). According to an expert witness for SIA, customers will believe that the Bank's financial resources stand behind Schwab in some manner and not realize that "BankAmerica" refers to the holding company and not the Bank (Mendelson Direct at 9-10; Mendelson Tr. at 1094).

117. BAC asserts that its association with Schwab will help Schwab overcome investors' apprehension of using discount brokers (BAC Application at 28, 29; BAC Proposed Findings 127-128). BAC's present marketing plans for Schwab do not misrepresent any aspect of Schwab's affiliation with BAC or the Bank (McLin Direct at 10; McLin Rebuttal at 2–5). Under the kiosk project the service will be identified to customers as "Stock Brokerage Services . . . Provided by Charles Schwab & Co., Inc." (McLin Rebuttal at 2). Customers wishing to place orders will deal directly with Schwab (McLin Rebuttal at 3-4).

118. While the precise liability of the Bank for the obligations of Schwab may not be fully comprehended by consumers (although the Schwab customer base consists of "Upscale" retail banking customers who have average incomes of about $60,000 per year—SIA Proposed Finding 311, and are knowledgeable concerning their investment alternatives—SIA Proposed Finding 95), Schwab will be a in a stronger financial and management position after its acquisition by BAC than before the acquisition (F. 76-81). Thus, there is little liklihood [sic] that consumer confusion about the nature of the affiliation between Bank and Schwab would occur or lead to any undue public harm.

G. *BAC's Incentives To Subsidize Schwab Services*

119. BAC regards cross selling of brokerage services to bank customers and banking services to brokerage customers an important aspect of the Schwab acquisition. In particular, BAC intends to develop new and attractive packages of brokerage and banking services to compete for customers and to win their business away from other providers of financial services, including brokerage firms (Prussia Direct at 3-5, 7; *see also* F. 103).

120. Banks earn greater than normal profits from the sale of certain banking services, such as on deposits with regulated interest ceilings and with low service costs relative to average balances (Mussa Direct at 23; Baxter Tr. at 434). Therefore, banks spend money to try to induce customers to put money into savings accounts on which the interest rate is regulated. For example, banks recently expended funds to obtain deposits in interest regulated All-Savers certificates (Baxter Tr. at 436). Banks also offer below-cost services in order to attract deposits into interest-regulated accounts (Baxter Tr. at 436). Banks also offer below-cost services in order to attract deposits into interest-regulated accounts (Baxter Tr. at 436; Jacobs Tr. at 558), and will continue to look for new avenues to attract more money into their regulated savings accounts (Baxter Tr. at 436).

121. A bank holding company has an incentive to subsidize the activities of a non-banking subsidiary, to the extent that the subsidized activities assist the affiliate bank in selling those services which earn greater than normal profits (Mussa Direct at 20; Mussa Tr. at 802). Further, a bank holding company may continue to subsidize a subsidiary so long as itstotal [sic] subsidy is compensated by other profits which are earned as a result of the subsidization (Mussa Direct at 20).

122. One of the benefits BAC expects to derive from its acquisition of Schwab is the ability to cross-sell the Bank's services to Schwab's upscale customer base (Mussa Direct at 29-32; Mussa Tr. at 801; SIA Exh. 55; *see also* F. 103). BAC expects to earn significant additional profits from this cross-

selling (Mussa Tr. at 801-02). BAC estimates that the acquisition of Schwab will result in adding over 15,000 additional California customers and 70,000 additional non-California customers to the bank (SIA Exh. 14 at 30; Mussa Direct at 35; Mussa Tr. at 814). Each additional upscale California and non-California customer is expected to add $150.00 and $30.00 respectively to the Bank before tax earnings for an annual increase in profits to BAC of $4.7 million (SIA Exh. 14 at 30; Mussa Direct at 34-35).

123. BAC has no plans to sell Schwab brokerage services below cost as a way of increasing the opportunity to cross sell its banking products (McLin Tr. at 39). None of the numerous acquisition documents in the record even suggests that BAC would embark on such a course of action (*see e.g.*, SIA Exh. 5, 7-10, 13, 14, 16-18, 20-34, 42, 44, 55, 56, 59). BAC's plans to gain Bank deposits from cross selling Schwab services does not call for any subsidy of Schwab's commission rates; the gain would come from convenience and efficiencies. In fact, BAC has an expectation that each affiliate will return 15 percent on equity capital (McLin Tr. at 24-25). BAC will not invest in Schwab unless it can anticipate an attractive long-term return on investment compared to alternative uses available for BAC funds (Prussia Direct at 8). Further, any subsidization of Schwab services would offset any gains to BAC from the practice, making subsidization largely self defeating.

CONCLUSIONS

I. *BAC's Proposed Acquisition Does Not Violate The Glass-Steagall Act*

The Glass-Steagall Act ("GSA") was enacted in 1933 in response to the economic crises of the 1930's and concomitant bank failures. As the Supreme Court noted in *Board of Governors v. Investment Co. Institute*, 450 U.S. 46, 61-62 (1981):

> "It is familiar history that the Glass-Steagall Act was enacted in 1933 to protect bank depositors from any repetition of the widespread bank closings that occurred during the Great Depression. Congress was persuaded that speculative activities, partially attributable to the connection between commercial banking and investment banking, had contributed to the rash of bank failures. The legislative history reveals that securities firms affiliated with banks had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank's own stock, often with the bank's resources." (Footnotes omitted)

The GSA contained many important provisions designed to improve the banking system, such as the creation of the Federal Deposit Insurance Corporation. However, through the years, the term GSA has generally come to refer to only four of its sections—those dealing with securities activities. These provisions may be summarized briefly as follows:

1. Section 21 of the Act, 12 U.S.C. 378, makes it a felony for an organization that receives deposits to "engage at the same time in the business of underwriting, selling or distributing . . . stocks, bonds, debentures, notes or other securities . . ."

2. Section 20 of the Act, 12 U.S.C. 377, prohibits affiliation between member banks and companies "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities . . ."

3. Section 32 of theAct, 12 U.S.C. 78, prohibits interlocking personnel relationships between member banks and companies "primarily engaged" in the securities business described in Section 20.

4. Section 16 of the Act amended an existing provision of the banking law (R.S. 5136, 12 U.S.C. § 24 (1970)) to (a) prohibit national banks and state member banks from purchasing any equity securities, (b) impose additional limitations on

their investment authority with respect to debt obligations, and (c) prohibit their underwriting and dealing in securities except for U.S. Treasury and other agency obligations and general obligations of states and municipalities. As thereafter amended by the Banking Act of 1935, Section 16 provides, in pertinent part, that: "The business of dealing in securities and stocks by the association shall be limited to purchasing and selling such securities without recourse, solely upon the order, and for the account of [sic] customers and, in no case, for its own account, and the association shall not underwrite any issues of securities or stock . . . . Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the corporation for its own account of any shares of stock of any corporation." 49 Stat. 709, Aug. 23, 1935, c. 614, § 308.

Immediately following the passage of the GSA, agencies and courts were reluctant to allow more than the most limited form of investment activity by banks. In 1936, for example, the Comptroller of the Currency allowed the purchase and sale of securities by national banks only to existing bank customers and only if the bank received prior payment or had customer assets on hand to cover the transaction.

The scope of permissable [sic] securities activity has been greatly expanded since that time. The Comptroller has acknowledged that earlier interpretations of the banking regulations were reactions to the economic situation of the 1930's and interpret the GSA erroneously. *See Security Pacific National Bank*, Slip Op. August 26, 1982, decision by the Comptroller of the Currency at 4.

The rejection of the restrictive reading of the Act is supported by a number of judicial decisions. In *Investment Co. Institute v. Camp*, 401 U.S. 617 (1971), the court analyzed a bank's participation in the organization, distribution and marketing of shares in an investment company. The court held that the activities involved a bank in the underwriting and distribution of securities in direct controvention [sic] of Sections 16 and 21 of the GSA. However, in so holding, the court

expressly acknowledged that nothing in the law would prevent a national bank from purchasing stock for the account of its customers. 401 U.S. at 624.

In *Investment Co. Institute, supra*, the court found a Board regulation permitting bank holding companies and nonbanking subsidiaries to act as investment advisors to closed-end investment companies not to violate the GSA. The court distinguished the restriction of Section 21 which limits the scope of permissible activities of banks, and Section 20 which limits the activities of bank affiliates:

> Even if we were to assume that a bank would violate the Glass-Steagall Act by engaging in certain investment advisory services, it would not follow that a bank holding company could never perform such services. In both the Glass-Steagall Act itself and in the Bank Holding Company Act, Congress indicated that a bank affiliate may engage in activities that would be impermissible for the bank itself. Thus, § 21 of Glass-Steagall entirely prohibits the sale firm from engaging in banking and in the underwriting business, whereas § 20 does not prohibit bank affiliation with a securities firm unless that firm is "engaged principally" in activities such as underwriting. [footnote omitted] (450 U.S. at 63-64)

Thus, the court acknowledged that affiliates of bank holding companies are to have greater authority to carry on activities related to securities transactions than are banks.

It is clear, therefore, that Section 20 is the principle provision to be examined in the context of the BAC application; it deals with relationships of member banks and securities affiliates. The section prohibits affiliates from engaging principally in "the issue, flotation, underwriting, public sale or distribution" of securities.

Schwab buys and sells securities solely on the order and for the account of customers. It does not engage in market making or more than a minimal amount of dealing or underwriting.

The only securities transactions in which Schwab engages that might be characterized as other than agency transactions are the "inadvertent principal" transactions that arise as a result of errors in executing customer orders, the "riskless principal" transactions in connection with the purchase and sale of new issue municipal bonds, and the "sweep" arrangement with the Kemper Cash Equivalent Fund. Together these activities constitute a very minor portion of Schwab's business (F. 12, 13, 64-66). Thus, Schwab is not "principally" engaged in the "issue, flotation [or] underwriting" of securities.

The principal barrier to the acquisition of Schwab by BAC, therefore, is the remaining language of the section prohibiting the "public sale" of securities. The meaning of this phrase in Section 20 and its relationship to brokerage activities has not been explicitly defined (*see* Board Counsel's Post Hearing Brief at 20). Section 32, however, which contains parallel and virtually identical language equivalent to that of Section 20, has been interpreted by the Supreme Court.

In *Board of Governors v. Agnew*, 329 U.S. 441 (1947), the court apparently accepted the proposition that the Section 32 language did not refer to brokerage activity. The court in *Agnew* addressed the issue of the applicability of Section 32 of the GSA, which prohibits simultaneous employment of persons in both a securities firm and a bank, to a question of whether a securities firm, Eastman Dillon & Co., was primarily engaged in underwriting activities of the type enumerated in Section 32. Like the Board and the court before it, the Supreme Court accepted an interpretation of Section 32's securities underwriting language which clearly excludes brokerage activities from the section's limitation. The court determined that only the gross income from the underwriting field, which consists of income from "[T]he issue flotation, underwriting, public sale or distribution . . . of stocks, bonds or other similar securities . . ." (329 U.S. at 445 fn.3), should be considered in a determination of whether the statute had been violated. Gross income from brokerage business was not to be considered in

any determination as to whether a firm was "primarily engaged" in any activity violative of the act. This interpretation that the phrase "public sale" excludes brokerage activities is consistent with earlier Federal Reserve Board interpretations.[6]

As noted above, the only activities in which Schwab engages that even remotely raise a question under the language of Sections 20 and 32 are Schwab's "sweep" arrangement with the Kemper Cash Equivalent Fund, a money market fund, the "riskless principal" transactions in connection with the purchase and sale of new issue municipal bonds,[7] and the "inadvertent principal" transactions that arise as a result of errors. None of these activities, as performed by Schwab, are significant enough to warrant finding the proposed acquisition to be a violation of the GSA. In no event do they constitute a "principal" activity within the meaning of Section 20 as interpreted by the court in *Agnew* (329 U.S. at 446-49).

In determining the propriaty [sic] of permitting a bank holding company to acquire a discount brokerage firm the undersigned is mindful of the intent of the framers of the GSA. While Congress meant to "seperat[e] [sic] as completely as possible" commercial from investment banking, *Board of Governors v. Investment Co. Institute,* 450 U.S. at 70, it specifically authorized banks to carry on some securities activities. Section 16 of the Act sets forth the permissible securities activities of banks that are members of the Federal Reserve System as follows:

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6 The Board determined in 1936 that:

> A broker engaged in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32. (12 CFR § 218.1 n. 1 (1936)).

7 The purchase and sale of municipal bonds are authorized for banks and need not be considered (12 U.S.C. 24 (Seventh) [sic]. Banks in the past have engaged in trading in municipal bonds on a substantial scale (F. 41).

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock. 12 U.S.C. § 24 (Seventh).

The only discussion of the Section 16 limitation on brokerage activities and their function, as contemplated by the GSA, is contained in the Senate Report which explains the purpose of Section 16:

> Section 16.—Undertakes to broaden the national laws by giving national banks all powers possessed by State banks of deposit and discount organized in the States in which such national banks are located, except in so far as they may be prohibited by Federal legislation. National banks are to be permitted to purchase and sell investment securities for their customers to the same extent as *heretofore* . . . " (Emphasis supplied). S. Rep. No. 77, 73d Cong., 1st Sess. 16 (1933).

Because Congress intended to permit banks to continue the securities activities engaged in prior to the enactment of the GSA, it is necessary to examine the pre-1933 brokerage functions of national banks.

Prior to enactment of the GSA brokerage activity by national banks was so widespread it was subject to judicial notice. *Block v. Pennsylvania Exchange Bank,* 253 N.Y. 227, 170 N.E. 900 (1930). Among the practices undertaken by banks were the charging of customer accounts for purchases rather than having the customer draw a check to cover the purchase price, the charging of a service fee for transactions and the dealing in both debt and equity investments. *See e.g., Blakey v. Brinson,* 286 U.S. 254 (1932), and *McNair v. Davis,* 68 F.2d. 935, (5th Cir. 1934), *cert. denied,* 292 U.S. 647 (1934).

More recently, Section 16 has been interpreted so as to permit increasing brokerage-type activity by banks. In

N.Y.S.E. v. Smith, 404 F. Supp. 1091 (1975), *vacated and remanded for dismissal on other grounds,* 562 F.2d 736 (D.C. Cir. 1977), *cert. denied,* 435 U.S. 942 (1977), the court validated a ruling of the Comptroller of the Currency holding that automatic stock-purchasing services offered by National banks did not violate the GSA. Automatic Investment Services ("AIS") provide participants the opportunity periodically to invest predetermined amounts in equity securities selected by them from a list compiled by an administering bank. Banks purchase the necesary [sic] shares in the market and hold the shares for the account of the participants. AIS's were first introduced in 1973, prior to the unfixing of brokerage commissions. They provided a means by which individual purchasers of small numbers of shares could take advantage of lower commission rates for bulk sales (see F. 38).

Plaintiff in *N.Y.S.E. v. Smith* contended that even though the AIS met the letter of Section 16, it failed to comply with the spirit of the Act. Plaintiff argued that Section 16 was intended to be a narrow exception to the general ban on participation in securities-related activities limited to providing a service for established customers as a courtesy. The Plaintiff also argued that the supplying of free checking accounts to AIS participants rendered compliance with the statutory requirement of a customer relationship a mere technicality. In finding no violation of the spirit of the GSA the court reiterated the Supreme Court's reasons for finding a conflict between allowing a bank-managed investment fund and the purposes of Section 16, as stated *Investment Co. Institute v. Camp, supra.*[8]

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8 The reasons advanced by the court for finding a conflict between a bank-managed investment fund and the strictures of Section 16 of the GSA were: (1) the fund gave the bank a salesman's interest in the investments; (2) the bank had a salesman's interest in the sales of shares in the fund; (3) the bank's prestige and credibility were placed in jeopardy; and, less importantly, (4) banks might lend money to corporations in which the fund had invested, or to the fund or customers of the fund in a manner not in keeping with sound business judgment. *See,* Investment Co. Institute v. Camp, 401 U.S. at 636-38.

In concluding that AIS activities violate neither the letter nor the spirit of the GSA, the Court in *N.Y.S.E. v. Smith* noted:

> Banks offering AIS do not have a salesman's interest in the securities' performances. Since the banks do not manage the customers [sic] investments, they need not prove that they perform better than anyone else. This is quite different from the situation in *Investment Company Institute*, where banks were compelled to out perform mutual funds. Under AIS, banks are in competition with investment brokers only in terms of convenience, cost, and dependability. This sort of competition does not engender the threats to bank solvency which concerned the drafters of the Glass-Steagall Act because it is independent of any investment decision. 404 F. Supp. at 1099-1100.

Congress's express grant of brokerage powers to banks (12 U.S.C. § 24 (Seventh); *see also Investment Co. Institute v. Camp*, 401 U.S. at 624), demonstrates that Glass-Steagall's major concern is with bank involvement in underwriting and dealing, and not brokerage. Unlike the underwriting business, the proposed discount brokerage activities engaged in by Schwab will not cause BAC (or its bank subsidiary, Bank of America NT&SA) to put its own assets or funds at risk in the securities markets. It is thus apparent that Glass-Steagall's policy would not be thwarted by allowing bank holding companies to engage in securities brokerage.

In an August 26, 1982 decision, the Comptroller of the Currency approved an application from Security Pacific National Bank to offer discount brokerage services through a subsidiary (*Security Pacific National Bank*, Decision of the Comptroller of the Currency (Aug. 26, 1982)). Although not binding on the Board, the decision is further evidence of a broadening of the scope of permissable [sic] activities of banks. The Comptroller stressed and the undersigned agrees that the kinds of brokerage activities associated with the discount brokerage business do not give rise to risks materially

different from those associated with the securities activities historically pursued by banks and therefore in no way violate the precepts of the Glass-Steagall Act.

II. *Schwab's Activities Are "Closely Related to Banking"*

A. *The Criteria for Determining if an Activity is Closely Related to Banking*

Under Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8), bank holding companies are permitted to engage in "activities . . . which the Board has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."

In determining whether an activity is "closely related" to banking, the Court of Appeals for the District of Columbia, in *National Courier Association v. Board of Governors*, 516 F.2d 1229 (D.C. Cir. 1975), set forth a series of guidelines, which have since been adopted by the Board. *See, e.g., Citicorp (Citishare)*, 68 Fed. Res. Bull. 505, 506 (1982). Pursuant to these guidelines, an activity will be considered closely related to banking if:

1. Banks generally have in fact provided the proposed services;
2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services; or
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

(516 F.2d at 1237).

The *National Courier* court noted that the Board is not limited to the above three standards.[9] After recapping the

9 The Board has held that it "may consider other factors in deciding what activities are closely related to banking." BankAmerica Corp., slip op. at 3 (Fed. Res. Board Sept. 1, 1982).

National Courier guidelines, the court in *Ala. Assoc. of Ins. Agents v. Board of Governors of Federal Reserve System*, 533 F.2d 224, 241 (1976), stated a willingness "to consider broader types of relationships.[10] In that case the court affirmed the Board's authorization of the sale of property damage insurance by banks despite the fact that there was no history of banks supplying such insurance nor any necessity for a specialized form of the activity. The justification for the approval was the fact that both the bank and the customer were in need of such insurance. As the court noted:

> Where a product or service is regularly desired by both parties and supports the transaction in some significant way, we cannot say that the Board acts irrationally or arbitrarily in deeming the furnishing of the product or service 'closely related to banking' or 'directly related to an extension of credit.' (533 F.2d at 244)

Similar guidelines have been used by the Supreme Court. In *Board of Governors v. Investment Co. Institute*, 450 U.S. 46 (1981), the court sustained a Federal Reserve Board ruling, pursuant to Regulation Y, that acting as an investment advisor to and manager of a closed-end investment company was closely related to banking. The court found the principal activities of the advisor—the investment of client funds and the management of an investment portfolio, were "not significantly different from the traditional fiduciary functions of banks" (450 U.S. at 55-56) and that banks had been engaging in the activities for decades.

Earlier this year the Board characterized the relevant criteria as follows: "As the courts have made clear, a proposed activity that does not differ significantly from the functions that banks traditionally or generally have provided is closely related to

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10 ". . . we believe the Board should be upheld when it articulates any type connection between banking and the non-banking activity in question which makes it rational to consider the proposed activity an 'incident' to banking." 533 F.2d at 244.

banking within the meaning of Section 4(c)(8)." *Citicorp*, 68 Fed. Res. Bull. 249 (1982).

In addition to closely related activities, the Board's Regulation Y authorizes bank holding companies to perform "such incidental activities as are necessary to carry on the closely related activities." 12 C.F.R. § 225.4(a) (1981). The *National Courier* court endorsed this concept stating:

> "[T]he idea is fairly well established that Congress intended some reasonable latitude in the limitations it placed upon the activities of banks and their affiliates. In enumerating the activities that could be carried on, it certainly could not have meant to forbid engagement in such other 'incidental' activities as were reasonably necessary to carrying out those that were enumerated." (516 F.2d at 1240).

BAC's proposed acquisition of Schwab is not barred by Section 4(c)(8) of the Bank Holding Act [sic], because each of the activities intended to be carried on by the new acquisition is either closely related to banking or so related to such activity as to be reasonably necessary in carrying out the closely related activity.

B. *Schwab's Discount Securities Brokerage Activities are "Closely Related to Banking"*

BAC proposes to engage through Schwab, in the business of acting as broker for the purchase and sale of securities upon the order and for the account of customers in substantially the same manner as Schwab currently conducts that business. Schwab presently buys and sells securities solely on the order and for the account of customers. It does not engage in the market making and it gives no investment advice (F. 12). The issue is whether these activities if performed by a subsidiary of BAC are functionally or operationally so similar to activities already performed by banks as to be "closely related" to banking under Section 4(c)(8) of the Bank Holding Company Act ("BHC Act").

Recommended Decision

The record shows that banks have participated in stock brokerage activities through six principal programs (F. 33-41). First, banks have offered Customer Transaction Services, whereby the bank agrees to purchase or sell stock on behalf of and at the direction of the customer. The SEC's Initial Report on Bank Securities Activities concluded that as of 1976, more than 4,300 commercial banks (30%) offered this service (F. 35). Second, banks have offered Dividend Reinvestment Plans, whereby shareholders of a corporate customer of a bank authorize the payment of dividends to a bank that will purchase additional shares of the corporation on their behalf. Some banks provide shareholders the option of investing other funds in the purchase of additional stock. As of 1977, 68 banks (0.5%) administered such plans for 727 companies (F. 36). Third, banks have offered Employee Stock Option Plans that provide a method for employees of a customer corporation of a bank to invest in securities of the corporation by periodic deductions from payroll deposited with the sponsor bank. As of 1977, 59 banks (0.4%) offered the plan (F. 37). Fourth, banks have offered Automatic Investment Services that are brokerage plans initiated by banks that compile a list of 20-30 securities that are subject to purchase and sale by the bank through individual custodial accounts. By purchasing large numbers of shares at one time the bank is able to pass substantial savings in transaction costs to individual purchasers. Since the unfixing of brokerage commissions in 1975, AIPs have not been profitable and have been discontinued by most banks that offered them. As of 1977, 18 banks (0.1%) provided the service (F. 38). Fifth, it has been shown that brokerage activities on behalf of bank trust accounts constitute the largest portion of bank securities brokerage activities. The trust departments of banks offer service to a wide variety of customers, the services provided include arranging for the purchase and sale of securities, holding securities for trust accounts; collecting dividends and crediting them to interest bearing accounts. Banks may or may not offer investment

advice to these customers (F. 39-40). Sixth and finally, banks are active participants in marketing obligations of the United States and its agencies, general obligations of states and municipalities, municipal revenue bonds, and money market instruments such as certificates of deposit and bankers acceptances (F. 41).

As the SEC concluded in its "1977 Final Report on Bank Securities Activities," many such bank activities are "functionally equivalent to those of broker-dealers." In particular, the SEC concluded that "with respect to the purchase and sale of securities for their managed accounts, bank trust departments are performing in many respects the same activities as are performed by retail brokerage firms" (BAC Exh. 54 at 6, 121). The SEC also concluded, "the extent of this bank activity is substantial, both for trust department accounts and brokerage-type services" (BAC Exh. 54 at 14).

Banks are not members of exchanges and, therefore, do not execute customer orders themselves on exchanges. However, this is also true of many brokers, such as "introducing brokers," who rely on third parties to execute transactions involving listed securities. Until June 1982 Schwab relied on Pershing & Co. to execute and clear its trades on the New Your [sic] Stock Exchange; Schwab still uses Pershing for its options trading. Third party correspondent brokers, such as Pershing, offer the same execution and clearing services to both banks and brokerage firms. Even brokers that are members of exchanges on occasion rely on third parties to execute their transactions (F. 46). A customer rarely knows the manner in which his bank broker executes his order. Therefore, from his perspective, the results produced by asking a bank to act as agent to buy or sell a security and asking a securities broker to perform the same transaction, are identical.

Recently, a large number of banks have begun to provide expanded brokerage services to their customers pursuant to contractual arrangements with a variety of brokerage firms, including discount brokerage firms. On August 26, 1982, the

Comptroller of the Currency specifically authorized Security Pacific National Bank to provide discount brokerage services through a new subsidiary. And on September 20, 1982, the Comptroller approved the application of Union Planters National Bank of Memphis to acquire Brenner Steed & Associates, a discount brokerage firm. The Federal Deposit Insurance Corporation has similarly affirmed that banking institutions subject to its jurisdiction may engage in expanded securities brokerage activities through subsidiaries (F. 42, 43).

While there is not an exact correlation between those brokerage activities conducted by banks and securities firms, the differences are not fundamental and are matters of degree. Possibly the largest difference is the fact that banks have not frequently dealt with other than their banking customers. However, it is not consistent with the purposes of section 4(c)(8) to require a linkage of the security activity to its provision to the general public. The court in *National Courier Ass'n, supra,* explicitly recognized the irrelevance of the nature of the customer for closely related services when it observed that courier activities performed by a banking holding company affiliate

> " . . . may be between two places of business neither of which is a bank, a bank affiliate, or a customer of either. A bank related courier may thus carry the financially related records of a firm with which it has no dealings . . . to the independent data processor of that firm's choice." (516 F.2d at 1239).

SIA's principal quarrel with this "closely related" issue centers on the fact that banks have not executed trades on the major exchanges and the volume of brokerage activities transacted by banks has been small when compared to total brokerage revenues. Banks for many years have performed all brokerage activities except execution on major exchanges. Their brokerage activities in all other respects are operationally or functionally equivalent to or identical to the activities of

brokers, making banks particularly well equipped to engage in all brokerage activities. Further, over the course of past years the dollar volume of brokerage transactions by banks has been significant.

The differences that have existed between the securities activities of banks and full brokerage firms are the result of historical and economic circumstances. The pre-1975 environment of fixed brokerage commissions, coupled with the ineligibility of banks to become members of exchanges, precluded banks from profitably participating in the offering of brokerage services. These differences should not serve as a basis for further limitation of bank or bank holding company involvement in the brokerage industry.

C. *Margin Lending is "Closely Related to Banking"*

Schwab's margin lending activities are also closely related to banking. Banks have traditionally offered margin credit to their customers, pursuant to Regulation U of the Federal Reserve Board. Regulation U, which limits the amounts that banks may lend on stocks, has been in effect since 1936. As of the end of 1981, commercial banks had approximately $5 billion in loans outstanding to purchase or carry securities by borrowers other than brokers, securities dealers or other financial institutions. Margin lending by brokers is governed by Regulation T of the Federal Reserve Board. The fundamental activity in broker margin lending—making secured loans to individual customers—is functionally equivalent to bank margin lending, as well as general secured lending which is a fundamental bank activity (F. 41).

Margin lending is a major activity of brokers. Margin lending revenue accounted for 14.7% of total broker revenue in 1979 (F. 22). Forty-five percent of all trades executed by Schwab are conducted in margin accounts (F. 47). Thus, margin lending is also reasonably necessary to brokerage activity.

D. *IRA Accounts and Securities Custodial Services Offered by Schwab are Operationally and Functionally Equivalent to Services Offered by Banks*

BAC proposes to offer its brokerage customers access to a self-directed IRA account under an arrangement with an unaffiliated savings and loan association as trustee. Many banks offer IRA accounts to their customers. Numerous brokerage firms offer self-directed IRA account services to their customers (F. 49). Brokerage firms offer these accounts to compete effectively and to serve the needs of their customers. It, therefore, seems uncontroverted that the offering of such a service is an activity "closely related" to banking.

BAC also requests authority to offer securities custodial services similar to those currently offered by Schwab. Virtually all brokers offer custodial services whereby customers' securities are registered in street name and held in a depository on behalf of the customer. This activity entails safe keeping [sic], and accounting for dividends and interest received on securities so held and other ancillary administrative services (F. 48).

Schwab and other brokerge firms currently provide this service and, indeed, are required to keep possession of securities that are the subject of margin loans. Cash account securities certificates may be held by the customer, but approximately thirty-five percent of Schwab's cash account customers elect to use its custodial services. Approximately fifty percent of all Schwab customers use its custodial services (F. 48).

Banks have historically provided safekeeping and custodial services and bank holding companies may legally provide custodial service incident to their trust and advisory activities (12 C F R. §§ 9, 225 4(a)(4) and 225.125(i)). Bank holding companies may provide such services incidental to securities brokerage activities. *See, JCT Trust Co.*, 67 Fed. Res. Bull. 635 n.2 (1981). Accordingly, BAC's proposed securities custodial services are both closely related to banking and incidental to its proposed brokerage activity.

E. *Schwab's Investment Alternatives for Customer's Idle Funds Are Both Closely Related to Banking and Incidental to a Closely Related Activity*

BAC proposes to offer its customers the ability to invest their available cash balances, pending further investment, in securities. BAC proposes at least three alternatives:

(i) a "sweep" arrangement to an unaffiliated Kemper Cash Equivalent Fund, Inc.

(ii) payment of interest on net free balances

(iii) the Schwab One account, a cash management account, whereby, in addition to the payment of interest on free credit balances, the customer is provided a more comprehensive package of financial services, including a VISA credit card.

The record shows that these three services are widely offered by brokerage firms at the present time (F. 57-63).

During recent years, as the impact of inflation has increased the cost of having idle funds that do not earn a return and as consumers have become increasingly sensitive to the cost of leaving [sic] funds underutilized, brokerage firms have begun to make available to these customers a return on the cash balances in the customers' accounts. Virtually all brokers of any significant size offer their customers some mechanism through which they can earn a return on the available funds in their accounts pending further investment (F. 57).

Sweep Accounts are one method by which many brokerage firms, as well as banks and savings and loan associations, provide for a return on funds in customer accounts. Sweep accounts are money market funds that link existing security brokerage accounts and/or bank accounts to productive investments. Essentially, amounts above a specified minimum are regularly "swept" out of a customer's account with a bank or brokerage firm and into a money market fund, where it earns a higher rate of return. At present a number of brokers and

depository institutions offer retail sweeps in conjunction with independent money market fund management companies such as Fidelity, Federated, Kemper, or Dreyfus. Banks offering such sweep accounts include Chase and Bank of New York. Federated now claims to be offering this service to more than one hundred banks (F. 58).

In addition to offering "sweep" arrangements, some brokers, including Schwab, also pay interest directly on temporarily idle funds in their customers' accounts (interest on net free balances). The direct payment of interest on customer cash balances by brokerage firms is functionally equivalent to the payment of interest by banks on accounts such as savings accounts (F. 59).

Cash Management accounts are another means by which brokerage firms service their customers. It is a hybrid account, offering a number of financial services. Its main features usually include (I) [sic] the opportunity to earn interest on net free balances in a brokerage account, through either a money market fund functioning as a sweep account or the direct payment of interest, (2) a mechanism by which the customer can more readily redeem his funds, whether by check or by debit card, (3) the use of margin accounts to secure borrowing against eligible securities, (4) automatic features that tend to maximize returns received, through the establishment of a hierarchy of investments and redemptions (such that withdrawals are made from the least renumerative [sic] funds and investments are made to the highest yield funds), and (5) integrated monthly statements showing all account activity and balances (F. 60). Banks have been participants in the provision of cash management accounts since their initiation (F. 61).

All of the elements of these proposed mechanisms for utilizing idle customer funds are closely related to banking services. They are also increasingly necessary for effective competition for brokerage business (see F. 23, 57), and are therefore permissable [sic] under the Board's Regulation Y, which permits "incidental activities . . . necessary to carry on

the closely related activities" (12 C.F.R. § 2254(a)(1981)). The activities are also operationally or functionally equivalent to activities that banks are and have been engaged in, and are closely related to banking.

F. *Schwab's Inadvertent Principal Transactions and Money Market Fund Activity are Incidental to the Permitted Brokerage Activities*

"Inadvertent principal" transactions occur when Schwab makes a mistake in purchasing securities on behalf of a customer and must maintain (and then liquidate) the unwanted shares for its own account. Principal positions that arise as a result of errors are an unavoidable incident to the ordinary conduct of any agency securities transaction business and typically create a loss. Inadvertent principal positions arise in well below onepercent [sic] of all Schwab's business, which is incidental to their brokerage activities (F. 64).

Schwab offers a "sweep" arrangement in conjunction with the Kemper Cash Equivalent Fund (the "Fund"), a money market fund that is advised and administered by Kemper Financial Services, Inc. ("Kemper"), [sic] Schwab acts only as an agent for its customers in dealing with the Fund. It arranges for the purchase of shares in the Fund on behalf of the customers, processes the transfer of payments between the Fund and the customers' accounts, and generates periodic records for its customers reflecting their investment in the Fund. Schwab does not purchase shares in the Fund for its own account for resale to its customers, and receives no remuneration from its customers for these services it performs. The Fund maintains on its books the names of the Schwab customers holding an investment with the Fund and transmits all proxy materials directly to them. Under its agreement with Kemper, Schwab receives compensation from Kemper calculated on a sliding scale of different amounts in the Fund. Schwab is compensated for its *pro rata* share of the entire amount in the Fund, based on the shares its customers hold in

the Fund pursuant to Schwab's agreement with Kemper. For the fiscal year ending September 30, 1981, Schwab's payments from Kemper constituted less than one percent of Schwab's revenues (F. 66).

As noted earlier, sweep arrangements are "incidental" to the carrying on of a brokerage business and are therefore permissable [sic] under Regulation Y. The fact that Schwab earns less than one percent of its revenues from its arrangement reenforces [sic] this determination. As previously noted, banks presently offer sweep arrangements, leading to the plain conclusion that such arrangements are closely related to banking (F. 58).

III. *Public Benefits From The Acquisition*

A. *The Criteria For Determining Public Benefits*

Section 4(c)(8) of the Bank Holding Company Act provides, in part, that

> "in determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects."

12 U.S.C. 1843(c)(8).

In *Independent Ins. Agents of America, Inc. v. Board of Governors of the Federal Reserve System*, 658 F.2d 571, 573 (8th Cir. 1981), the court, in respect to the "public benefits" tests under 12 U.S.C. § 1843(c)(8), stated:

> "The Board in reviewing an application under 12 U.S.C. § 1843(c)(8), must make two separate determinations before such application can be approved. First, it must determine whether, as a general matter, the proposed activity is closely related and incidental to banking.

> *See, e.g., Connecticut Bankers Ass'n v. Board of Governors of the Federal Reserve System*, 627 F.2d 245, 249 (D.C. Cir. 1980). Second, it must determine whether the public benefits of the proposed activity will outweigh potential adverse effects. *Id. Accord, Independent Ins. Agents of America v. Board of Governors of the Federal Reserve System*, 646 F.2d 868, 869 (4th Cir. 1981) (per curiam). Twelve U.S.C. § 1843(c)(8) provides that in making the second determination, often referred to as the "public benefits" test, the Board must consider whether approval of the application "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." Under this two-step procedure, the Board can find that the proposed activity is closely related to banking in general but, nevertheless, deny the application because it fails the "public benefits" test. *See, e.g., Connecticut Bankers Ass'n v. Board of Governors of the Federal Reserve System, supra*, 627 F.2d at 249-250 nn. 19-21."

In making the "public benefits" determination:

> "[C]ongress required only that public benefits 'reasonably' be expected to outweigh adverse effects. In so doing, it indicated recognition of the fact that the judgments required of the Board are necessarily imprecise and to some degree speculative. Not only do they relate to complex future events—often unprecedented ones—but they concern aggregate rather than discrete effects. Thus, the Board must determine not whether there will be one or more aspects of insurance agency activity by holding company affiliates that will tend to produce efficiency gains, but whether, overall, such aspects will outweigh possible sources of efficiency loss sufficiently to produce

net gains. The latter determination is much more difficult than the former, and is one which is much less susceptible to detailed evidentiary support. Unless we are to impose insurmountable barriers upon those who seek to take advantage of the § 4(c)(8) authorization, which was reaffirmed by Congress in 1970, our review must be sensitive to these circumstances. *See, e.g., Bowman Transp., Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 292-94, 95 S. Ct. 438, 446, 42 L.Ed. 2d. 447, 460 (1974)."

Ala. Ass'n. of Ins. Agents v. Board of Governors of the Federal Reserve System, 533 F.2d 224, 246 (5th Cir. 1976). The burden of proof on the "public benefits" issue is on the applicant. *Id.* at 235 fn. 6.

B. *Summary of Public Benefits*

BAC's acquisition of Schwab will help make Schwab a more effective competitor and will allow BAC to compete vigorously in the emerging financial services industry. The strengthing [sic] of Schwab as a competitor is likely to result (a) from Schwab's greater acceptance by brokerage customers, (b) from support given Schwab in terms of capital spending (for office expansion, technological innovation and other purposes), management resources, and technological assistance,[11] and (c) from increased operational efficiencies. By making Schwab a more effective competitor, the acquisition promises to force competitive responses from other brokers, full-line firms and discounters alike, thereby increasing price and service competition in the brokerage industry.

BAC is a large multinational financial services conglomerate. It has a large management staff with great expeeence [sic] in many fields including areas where Schwab has not ventured.

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11 In 1980, Schwab had to abandon an attempt to access the public capital market because it feared a lack of public response due to its financial statements—bad debts and error ratios (BAC Application at 31; SIA Exh. 34 at 5).

For example, BAC has large scale foreign operations, an area where Schwab is just entering. BAC also has acquired technical skills in many operations, including data processing. BAC's management and technical resources should be of significant advantage to Schwab. In addition, the acquisition will allow BAC to participate in the increased competition that is occurring among many different types of financial institutions. As the differences among products offered by these institutions continue to blur, a more integrated financial services industry is emerging. The most successful new products include the transaction service offerings by brokerage firms which have provided attractive alternatives to the types of services previously offered only by banks. The proposed acquisition represents one way BAC seeks to respond to the competitive initiatives of brokers and to play a more competitive role in the broader financial services marketplace.

There has been a long-term trend toward consolidation within the securities industry as firms perceived the need to strengthen their financial structure and create a more permanent capital base. This trend has intensified in recent years as firms seek to compete more successfully with diversified financial firms, and to achieve economies of scale in such areas as data processing, communication, advertising and marketing (F. 23). The acquisition of Schwab by BAC strengthens Schwab in all of these areas.

C. *Increased Price Competition in Retail Brokerage*

BAC has presented straightforward propositions that enchanced [sic] acceptance of Schwab, coupled with Schwab's emphasis on competing on the basis of discount prices, will create public benefits in the retail brokerage industry where prices now are treated by the largest brokerage firms as trade secrets.[12]

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12 *See* Affidavit of Raymond V. Thomas at 6-7, appended as Attachment 1 to the Memorandum in Support of Joint Motion to Quash Subpoena Duces Tecum Dated August 19, 1982 (August 30, 1982).

Prior to May 1, 1975, securities brokerage firms in the United States provided most brokerage services first on a minimum and later on a fixed commission basis. As a result, price competition in the industry was virtually nonexistent, although brokerage firms did compete in the provision of services, including investment research and advice. After fixed commission rates were abolished, a high degree of price competition was quickly introduced into the "institutional" part of the brokerage business. With respect to individual customer transactions, however, the result was very different.[13] The large, established "full-line" brokerage firms have continued to compete on a service basis, without disclosing their commission rate policies.

Since May 1, 1975, "discount brokers" like Schwab, which compete for retail securities brokerage business on the basis of both services offered and price, have gradually emerged. The growth of discount brokers (F. 30) clearly indicates a substantial interest among consumers in obtaining brokerage services at a lower price and without "bundled" investment advice. There is reason to believe, moreover, that many customers of full-line brokerage firms who are potential customers of discount brokers, do not yet use such brokers. Among other reasons, this is because discounters are relataively [sic] new and relatively small and not well-established in the marketplace. As of 1981, discount brokerage firms accounted for only 6.1 percent of total industry commission revenues (F. 30).

The magnitude of the potential public benefit from increased price competition in the market for brokerage services is substantial. A distinguishing feature of "discounters" is that they advertise their prices aggressively. "Advertising is the traditional mechanism in a free-market economy for a supplier to inform a potential purchaser of the availability and terms of

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13 Commission rates on a per share basis to individuals show that they experienced an increase of 18.4 percent in trades under 200 shares, and an increase of 16.6 percent in trades between 200-900 shares (BAC Exh. 55, p. 83-93).

exchange." *Bates v. State Bar of Arizona,* 433 U.S. 350, 376 (1977). "Advertising serves to inform the public of the availability, nature, and price of products and services, and thus performs an indispensible role in the allocation of resources in a free enterprise system. Advertising serves individual and societal interests in assuring informed and reliable decision-making." *Id.* at 364. Price advertising places pressure on sellers to reduce prices, instills cost consciousness in providers of services and informs the public about price alternatives. *Advertising of Ophthalmic Goods and Services,* 43 Fed. Reg. 23,992, 23,994-95 (FTC June 2, 1978).

It is price competition that is the "central nervous system of our economy." *United States v. Socony Vaccum [sic] Oil Co.,* 310 U.S. 150, 226 n. 5 (1940). Increased competitive pressure on prices may well require full-line firms to lower their prices or increase their discounts.[14] When subjected to more price competition, some, if not all, such firms may decide to price brokerage services separately from research and advice services, allowing the market to allocate these services in a more direct and efficient way. Whether or not such "unbundling" occurs, strengthening Schwab in particular and discount brokers in general has substantial potential for benefitting investors by increasing price as well as service competition.

D. *Increased Competition for Technological Innovation*

The acquisition will help Schwab remain a leader in embracing new technologies that will continue to allow brokers to cut costs, reduce error rates, and generally provde better service. While Schwab has taken advantage of and led in the application of new technology to brokerage transactions, including an "on line" [sic] system of customer accounts and extensive use

14 "Quite simply, we consider potential cost to consumers an essential factor in the Board's net benefits determination under 12 U.S.C. § 1843(c)(8)." Independent Ins. Agents of America, Inc. v. Board of Governors of the Federal Reserve System, 658 F.2d 571, 576, fn. 7 (8th Cir. 1981).

of the automated execution services offered by various exchanges, further challenges will face it as it expands. Competitive pressures have led [sic] numerous brokerage firms, including the large SIA member firms, to rely increasingly on these automated systems (Biller Tr. at 313; BAC Exh. 80 [Affidavit of E.F. Hutton] at ¶ 4; BAC Exh. 82 [Affidavit of Merrill lynch [sic]] at ¶ 4; BAC Exh. 83 [Affidavit of Bache Halsey] at ¶ 4).

There is every reason to believe that adequate capital assistance from BAC will materially aid Schwab in remaining a leader in the adoption and development of new technologies, which will in turn benefit the public by reducing costs, reducing error rates, and increasing the speed with which transactions can be consummated and confirmed. Even though Schwab has been successful in the past in adapting new technologies, these technologies change rapidly and will be very expensive (Stupski Tr. at 72). Expansion from Schwab's present base may be more difficult and more expensive than in the past when Schwab was smaller. BAC can provide the management, technical and capital support that will assist Schwab in its continued growth and innovative efforts. This will provide still further benefits, as Schwab's competitive efforts elicit competitive responses from other firms in the industry.

E. *Increased Competition to Provide Financial Services Packages*

The acquisition will increase competition to provide new packages of financial services. Competition among all financial institutions has increased and has focused on providing consumers with attractive packages of financial services that cut across traditional industry lines. Limitations on interest that can be paid by banks nd savings and loan associations have contributed to the success of money market mutual funds in attracting funds away from banks. With the introduction of Merrill Lynch's Cash Management Account, a new type of package of attractive financial transaction services—including

a traditional brokerage margin account, the provision for market rates of return on available cash balances pending further investment, check writing privileges, a debit card, and other features—became available. Many major brokerage firms and banks have begun or planned to offer similar packages of services to their customers (F. 57-63).

The competitive impact of the proposed acquisition will have an effect on this larger market. With the offering of packages of services which combine brokerage accounts with transactional services such as checking and debit card account access, brokers have succeeded in winning customers away from banks. BAC, through its acquisition of Schwab, can complete to win back customers who have transferred their business from the Bank because of the convenience of the services offered by other financial institutions, and to win new customers by offering new attractive and convenient services. This effort will increase competition.

The mere filing of BAC's application to acquire Schwab has apparently already had some pro-competitive effects. Shortly after BAC's announcement of its plan, Security Pacific National Bank (a major California competitor of Bank of America) announced a joint venture program whereby it began to offer brokerage services to its customers (F. 42, 43). It can be anticipated that many other commercial banks, as well as savings banks and savings and loan associations, will follow suit, which can onlyenhance [sic] competition in the overall financial market.

F. *Increased Convenience*

The acquisition is likely to provide Bank of America customers with convenient brokerage services and Schwab customers with convenient banking services. A test program that holds promise for beginning this process is already under way, with the introduction of Schwab kiosks in Bank of America branches. BAC's support will also help Schwab accelerate its plans to make its services more available by expansion both in

this country and abroad. Technological growth and improvement should mean better customer service in the long run. Development of new packages of financial services also portends increased convenience to the consumer, since new combinations succeed only by offering greater value.

The offering of financial services packages and cross selling offer increased conveniences to customers. SIA members confirm that financial services packages offer more convenience to customers—they enable the creation of "better value and more convenience to the customers" (BAC Exh. 80 [Affidavit of E.F. Hutton]). "The ability to offer more than one product or service to the same customer creates possibilities for efficiencies and provide better value and more convenience to the customer" (BAC Exh. 87 [Affidavit of Dean Witter]).

Cross selling of products eliminates search costs for consumers who are able to purchase two products or services from the same supplier. BAC anticipates that its cross selling efforts will result in several thousand Schwab customers electing to become Bank customers (F. 103). This cross selling effort will be successful only if BAC can offer a better value and more convenience to such customers. BAC anticipates the cross selling effort will be successful, and so does SIA.

G. *Increased Efficiencies*

Many of the increased efficiencies that are likely to result from the acquisition have already been discussed and will be directly reflected in increased competition and in the offering of more convenient combinations of financial services to customers. In addition, the acquisition will lead to the sharing of management and other resources and to the direct financing of Schwab by BAC which will result in "efficiencies" in the sense that fewer resources will be used to produce the same goods.[15]

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15 With respect to the substantial potential for the sharing of computer resources, Mr. McLin, a BAC Senior Vice President, noted that "the bank basicially [sic] has idle capacity in their computer system at the time when Schwab is most busy and vice versa." (McLin Tr. at 35).

The convenience of cross selling to the customer also has efficiencies for the seller in both time and cost. This has been recognized by SIA members:

> "[C]ombinations of [financial] services create possibilities for substantial efficiencies in the use of the Company's facilities and assets, in marketing, and in the development of products which are themselves more efficient to administer. The Company believes that the offering of these multiple services is beneficial both to the company and to the public . . ." (BAC Exh. 80 [Affidavit of E.F. Hutton]; *see also* BAC Exhs. 81-83, 87).

IV. *No Significant Adverse Consequences Are Likely to Result From the Acquisition*

A. *The Alleged Adverse Consequences*

Section 4(c)(8) of the Bank Holding Company Act provides, in applicable part, that the Board should consider whether reasonably expected public benefits

> " . . . outweigh possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." 12 U.S.C. 1843(c)(8).

In its protest filed with the Board, SIA claimed that the competitive effects of BAC's acquisition of Schwab "should be gauged in the submarket for discount brokerage services" apparently based on claims of elimination of BAC as a "potential competitor" or "entrenchment" of Schwab as the largest discount broker (SIA Protest at 27). During the hearings herein SIA shifted its ground and apparently abandoned any claim of anticompetitive effects in the brokerage industry,[16] and instead

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16 SIA does propose findings to the effect that the acquisition will put other discount brokers at a competitive disadvantage to Schwab unless they become affiliated with a major bank, and failing this will be forced out of the market (SIA Proposed

raised claims of a probable lessening of competition among banks headquartered in California. Although not asserting any adverse effect on competition in the securities industry, SIA does claim that competitors may be adversely affected by "unfair" competition that may result from the acquisition. SIA also argues that if BAC is permitted to enter the brokerage field, it should be by *de novo* entry.

SIA's contentions of the adverse consequences of the acquisition are: (1) Schwab will have available an artifically [sic] low cost of capital; (2) BAC will have an incentive to price Schwab's services below cost; (3) Schwab will have unfair use of certain Bank privileges; (4) voluntary tie-ins between Schwab services and Bank services; (5) possible conflicts of interest by the Bank; (6) customer confusion; and (7) risks associated with Schwab's business.

B. *Competitive Effect in the California Banking Market*

There are 308 banks in California, thirteen have resources in excess of $1 billion, and five have resources in excess of $10 billion. As of December 31, 1981, the five largest California banks accounted for over 74% of all domestic deposits (40 [sic] firm concentration = 66%, [sic] and 76% of all domestic loans (4-firm concentration = 68% in California banks [sic].

The Bank, the largest bank in the United States and the dominant bank in California, had California domestic deposits, as of 1981, totalling $51,944 million. This represents 35.87% of all bank deposits in California. Although illustrative of the Banks [sic] relative size as compared to other California commercial banks, banking concentration does not fully reflect the alternative sources available to the public for

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Findings 327-328). If discount brokers are forced out of the market, it will be because they cannot offer the attractive combination of products and services which banks will be able to offer. Additionally, the Board's concern should be directed at competition, not competitors. (*see* BankAmerica Corporation (Decimus), 66 Fed. Res. Bull. 511, 515 (1980).

all the different banking services in a local market.[17] For example, when savings and loan association deposits are added to bank deposits, the Bank's share of total deposits becomes 20.27% (F. 95, 96).

Recent developments in financial services have significantly eroded the uniqueness of the products that commercial banks can offer. For example, in offering deposit services, California commercial banks compete with savings and loan associations and credit unions in California and with money market funds available nationwide. In making mortgage loans, California commercial banks compete with savings and loan associations, mortgage bankers, insurance companies, and a variety of other lenders located both inside and outside of California. In making consumer loans, California commercial banks compete with savings and loan associations, finance companies, credit unions, retail merchants, and a variety of other lenders in California, as well as with banks and other institutions located outside of California. In making business loans, California commercial banks compete with out-of-state bank loan production offices, savings and loan associations, finance companies, insurance companies, money market funds and other institutional purchasers of commercial paper, and a variety of other lenders (F. 97).[18]

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17 Herfindahl indices based on total bank deposits in California by SMSA, and total bank deposits and savings and loan association deposits combined by SMSA, have been calculated (F. 101, 102).

18 In connection with research for a book published in 1979, Professor Mussa, SIA's expert witness, made a study of competition among commercial banks and concluded that:

> "In the loan markets, where banks 'sell' credit, they compete on a local, national, and international basis with other banks, with nonbank financial institutions, and with direct credit market instruments. There can be little doubt that these credit markets are highly competitive." (BAC Exh. 75 at 135 [Mussa & R. Kormendi, The Taxation of Municipal Bonds: An Economic Appraisal (1979)]).

An explicit rationale of BAC for the proposed acquisition of Schwab is its desire to expand the Bank's customer base. It is hoped that present Schwab customers in California will move their banking deposits to the Bank thereby increasing its deposit base. BAC estimates, and SIA agrees, it may reasonably expect to acquire 15,000 California customers from its association with Schwab. With an estimated gain in deposits of $10,000 per new customer, an overall increase in Bank deposits of $150 million can be anticipated, which represents an overall gain of approximately three-tenths of one percent of the Bank's total deposits (F. 103).

Undue concentration of resources is specifically mentioned in the statute as a possible adverse effect of a bank holding company affiliate activity (12 U.S.C. 1843(c)(8). The court, in *Ala. Ass'n of Ins. Agents v. Board of Governors of the Federal Reserve System*, concluded that apparently ". . . Congress believed that concentration of economic resources in a single entity beyond a certain point was harmful regardless of the proven existence of any anticompetitive effects of such concentration." 533 F.2d 224, 251 (5th Cir. 1976) From this it is gathered that proof of undue concentration of resources is an adverse effect, without the necessity of proof of actual anticompetitive effect. The determination of what is "undue" concentration of resources was primarily committed to the Board by Congress. *Ibid.*

Here SIA's challenge is not to any undue concentration of resources in the brokerage industry where the acquisition if [sic] being made, but undue concentration of resources in banking in California. The substantial concentration of resources held by the Bank cannot be denied. However, it is the additional resources to be added to the Bank's existing resources that is the concern of this proceeding, and that addition is *de minimus,* i.e., three-tenths of one percent of the Bank's total deposits.[19] It is also relevant to note that this

19 No court or agency has ever found, even as to a horizontal merger which eliminated an existing competitor, that an ex-

prospective increase in the Bank's deposits, the concern of SIA, is not by virtue of the acquisition itself, but because of gains expected to be realized through cross selling—the offering of a better and more convenient product to consumers.

Although not made an issue by SIA, the resulting increase in BAC's equity capital by reason of the acquisition of Schwab would also amount to only three-tenths of one percent (Schwab's stockholder equity is $12 million versus BAC's equity capital of $4,091 million—F.3, 10).

Because of the Bank's dominant position in the California market, any potential increase in the Bank's market power is cause for concern, and must be considered an adverse effect in the overall net "public benefits" test.

C. *Capital Cost Advantage to Schwab*

SIA contends that Schwab will enjoy an artificially low capital cost by virtue of its acquisition by BAC. This alleged advantage arises from the contention that banks and other depository institutions are effectively guaranteed against any significant risk of loss by government agencies, and those who control lendable funds are willing to lend those funds to large commercial banks on more attractive terms because of the lower risk attendant on such loans (SIA Proposed Findings 216-223).

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pected increase in a market share of only 3/10th of one percent would have an adverse effect on competition; and the Federal Reserve Board has expressly concluded that increases of such a small amount would be inconsequential. *See, e.g.,* FTC v. Tenneco, Inc., 433 F. Supp. 105 (D.D.C. 1977) (holding that 0.3% market shares was *de minimis*); Warner-Lambert Co., 87 F.T.C. 812, 904 (1976) (holding market shares of 0.1% and 0.2% *de minimis*). Greater New Jersey Bancorp., 68 Fed. Res. Bull. 239 (1982); National City Corp., 67 Fed. Res. Bull. 52 (1980) (0.1% *de minimis*); Central Bancshares, Inc., 64 Fed. Res. Bull. 674 (1978); National Bancshares Corp., 64 Fed. Res. Bull. 887 (1978) (0.1%); Marine Corp., 63 Fed. Res. Bull. 1090 (1977) (0.4%) increase.

It is common practice for parent companies to provide money to their subsidiaries in the form of equity capital and loans in order to meet the funding requirements of the subsidiaries. An acquired company which is funded by its parent may experience lower funding costs after the acquisition for several reasons, including the strengthening of the subsidiaries' economic potential and lessening of its risk as part of a larger enterprise, and on account of efficiencies with respect to transaction costs and evaluation of the risks which the subsidiary faces (F. 87). SIA apparently does not challenge these efficiencies, but is concerned about an artifically [sic](based on the bank's credit rating) low cost of capital.

Banking laws restrict lending by a bank to its parent holding company and to that holding company's non-banking subsidiaries so severely as to make such lending impracticable. Thus, BAC, not the bank, is the source of funding for its non-banking subsidiaries. BAC will be able to provide capital to Schwab in a manner more efficient and at Iower [sic] cost than the alternatives available to Schwab were it to enter the capital markets directly (F. 89).

The record evidence supports a conclusion that bank holding companies in general and BAC in particular, do not raise money at lower rates than other Iarge [sic] firms. In fact, bank holding companies incur somewhat higher marginal costs for short, medium, and long-term funds as compared to large industrial and non-bank related financial firms (Kimmell Rebuttal at 4). The testimony and affidavits of officials of BAC, Merrill Lynch and Bache Halsey Stuart (brokerage subsidiary of Prudential), show that the commercial paper rates of BAC were, if anything, slightly higher than the commercial paper rates of Merrill Lynch, Sears, and Prudential for the period May through July of 1982. Statistics published by the Federal Reserve Board indicate that BAC's commercial paper rates during the period May through July 1982 were generally the same or higher than both the rates on commercial paper placed

for other firms whose bond rating is AA or the equivalent and the rates on commercial paper of firms which placed their commercial paper directly (F. 94). In *Automobile Leasing As an Activity for Bank Holding Companies*, 62 Fed. Res. Bull. 930, 936 (1976), the Board found that large independent firms in the automobile leasing business have approximately the same borrowing costs as bank holding companies and that any cost disparities in the case of smaller independent firms are based principally on relative size. On that basis, the Board concluded that automobile leasing subsidiaries of bank holding companies would not have an "unfair" competitive advantage on account of their access to low cost funds.

In enacting the Bank Holding Company Act of 1956, and again when it amended the Act in 1970, Congress expressly recognized that public benefits—not detriments—flow from the ability of bank holding company subsidiaries to borrow money from their parent companies. Indeed, the Senate Committee recommending passage of the initial legislation expressly rejected the suggestion that bank holding company subsidiaries be required to obtain funds from sources other than their parents. As the committee reported in 1955:

> "The bill does not prohibit the borrowing of funds by any subsidiary in the system from the parent bank holding company. *Such downstream financing is one of the beneficial advantages cited to your committee in the use of the bank holding system technique*. Downstream financing enables the bank holding company to draw on the equity capital of its shareholders and its own operating funds in order to strengthen the financial condition of any one or more of its subsidiaries."

S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955) (emphasis added). Consistent with Congress' view, the Board has repeatedly recognized that public benefits—not adverse consequences—flow from the ability of a bank holding company to

provide funds to an acquired company at a lower cost than the acquired company otherwise could obtain.[20]

BAC in the past has used formulas for setting short and long-term rates to be used in making loans to affiliates (F. 90-91). The short-term is the average commercial paper rate paid by ten top-rated firms (not including BAC or the Bank). The formula for the long-term rate assumes that funds supplied by BAC and used by the subsidiary were acquired in equal monthly amounts over the preceding 60 months and a "composite," or "pool" rate is then calculated. Since over the past 60 months interest rates have risen in a considerable amount, the "pool" rate based on the earlier years was much less than the going market rates exisiting [sic] during much of the period 1980-1982. Thus, it appears that the long-term pool rate provided BAC affiliates an unusually low cost of capital during recent years.[21] However, if interest rates tend lower, which they have over the last few months, BAC's "pool" rates based on the high rates prevailing in 1980-82 will exceed the going market rate.

The charges to BAC's subsidiaries are designed to and do reasonably approximate BAC's own cost of funds.[22] BAC

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20 *E.g.*, Manufacturers Hanover Corp., 66 Fed. Res. Bull. 599, 600 (1980); Bank of New York Co. [sic] 66 Fed. Res. Bull. 793, 794 (1980); Mellon National Corp., 62 Fed. Res. Bull. 702, 707, 708, 721 (1976); Security Pacific Corp., 62 Fed. Res. Bull. 634, 635 (1976); Depositors Corp., 60 Fed. Res. Bull. 312 (1974); First Virginia Bankshares Corp., 59 Fed. Res. Bull. 202, 203 (1973).

21 For example, the long-term pool rate for five year money in 1981 averaged ten percent (Mussa Direct at 17). Yet, in 1981, BAC borrowed $250 million for eight years at 16¼ percent (BAC Exh. 2 at 40).

22 The parties argue at length about BAC's marginal cost of funds. The marginal cost of funds is, by definition, the cost of

would have no incentive to provide funds to Schwab unless it could expect to receive a return equal to the marginal cost to it of making these funds available, including an appropriate return for the risk incurred. Thus, it does not appear that Schwab will have an artificially low cost of capital. While BAC will be able to provide Schwab capital funds at a lower cost than Schwab could obtain on its own, this is an inherent advantage of the acquisition, a public benefit and not an adverse consequence.

D. *BAC's Alleged Subsidy of Schwab's Services*

As previously noted, BAC intends to expand its total customer base by cross selling bank services to Schwab customers. BAC regards cross selling of brokerage services to bank customers and bank services to brokerage customers an important aspect of the Schwab acquisition (F. 103, 122). Since banks earn greater than normal profits from the sale of certain banking services, such as on deposits with regulated interest ceilings and with Iow [sic] service costs relative to average balances, banks spend money to try to induce customers to deposit money into savings accounts on which the interest rate is regulated.

BAC expects to be able to cross-sell the Bank's services to Schwab's upscale customer base. BAC estimates that each additional California customer of the Bank who has the same financial characteristics as Schwab customers may be expected to add $150.00 per year to the Bank's before-tax earnings while each non-California customer will add $30 per year. BAC estimates that acquisition of Schwab will result in adding more than 15,000 additional California customers and 70,000 additional non-California customers to the bank and increasing

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borrowing the last dollar. Instead os [sic] using its marginal cost of funds in making loans to affiliates, BAC uses formulas consisting of its *average* cost of funds over a period of time. These averages fairly reflect BAC's actual cost of funds.

BAC's annual profits by $4.7 million (F. 122). Thus, SIA contends BAC would be willing to subsidize Schwab to the extent of $4.7 million to retain or expand Schwab's existing customer base (SIA Proposed Finding 277).

None of the numerous acquisition documents in the record even suggests that BAC would embark on such a course of action. BAC's plans call for the Bank to gain Bank deposits from cross selling Schwab services, not from any subsidy of Schwab's commission rates. Thus, the gain would come from convenience and efficiencies. In fact, BAC has an expectation that each affiliate will return 15 percent on equity capital. BAC will not invest in Schwab unless it can anticipate an attractive long-term return on investment comparable to alternative uses available for BAC funds (Prussia Direct at 8). Further, any subsidization of Schwab services would offset any gains to the Bank from the practice, making subsidization largely self defeating.[23]

While there are incentives present for subsidization, such practice is usually found where the recoupment of losses is expected to be gained in the same line of business at a later date. *See*, Areeda & Turner, *III Antitrust* ¶ 711b, at 151-52. There is no contention tht BAC would recoup its alleged subsidization losses in the brokerage market at some future date.

It is concluded that there is no credible evidence that subsidization is likely to occur or that any substantial adverse effects can be anticipated from such a practice.

E. *Alleged Unfair Use of Bank Privileges*

The Bank serves as an underwriter of certain general obligation municipal bonds, and it maintains a trading inventory of $135 million of such securities. The Bank is the predominant bank underwriter and dealer in municipal bonds in California. Municipal bonds are not traded on exchanges and must be

23 *See* BAC Posthearing Brief, pp. 68-70.

purchased (or sold) through dealers who carry such bonds (F. 82).

Under the Munimart arrangement, developed after the announcement of BAC's proposed acquisition of Schwab, Schwab carries out orders for municipal bonds for its customers by obtaining a quote from the Bank on the desired bond. If the Bank does not possess the precise bond requested by Schwab's customer, then the Bank will offer quotes on similar bonds in its inventory, which quote the Schwab employee will pass on to the customer. If the customer agrees to make the purchase after learning of the bond's availability, Schwab will buy the bond from the Bank's bond department for immediate resale to the customer. In only about half the bond transactions it carries out do Schwab customers specify the particular bond desired (F. 83).

Banks have a special tax privilege allowing them to deduct the entire carrying costs for their inventories of municipal bonds in determining their federal tax liabilities. The IRS does not permit broker-dealers who hold inventories of tax-exempt municipal bonds to deduct interest paid on that fraction of their debt that is assigned to the carrying of municipal bonds. Therefore, commercial banks that operate as traders of municipal bonds have a significant tax advantage relative to securities dealers that trade the securities. The Bank would realize this tax advantage on the bonds out of inventory which are sold through the Munimart arrangement with Schwab (F. 85).

Bank holds in inventory municipal bonds which it sells to other brokers and dealers at the same price at which it sells to Schwab. The Bank and other dealer banks and broker/dealers advertise in the blue list the bonds in their inventory which they wish to sell through the same, nationwide medium. There is no reason to believe that Schwab will receive any artificial advantage as compared to other firms that buy municipal bonds from the inventories of the Bank, dealer banks, and broker/dealers. The Munimart arrangement between BAC and Schwab at most presents an opportunity for the Bank to sell some

municipal securities to Schwab customers that it might not otherwise sell through its underwritings. This is a matter of cross selling and efficiencies of being an affiliate. Schwab receives no better price from the Bank than other broker/dealers. The tax advantage to the Bank exists as a matter of law and acquisition of Schwab will not change this advantage in any significant respect.

F. *Voluntary Tie-Ins*

SIA contends that the acquisition of Schwab by BAC presents a threat of voluntary tie-ins. A voluntary tie-in occurs when a customer believes that he or she would have a better chance of obtaining a certain restricted product from a company if the customer purchased another product from the same company and the customer actually does purchase that other product because of this belief. Where a concern's market power is visible to the individuals who are dependent upon the services or products of a particular enterprise, individuals will voluntarily purchase other products from the same enterprise in the hope that it will increase their opportunities of purchasing the desired product (SIA Proposed Findings 329-330).

Joint purchases—that is, purchasing two different goods or services from the same supplier at the same time—occur frequently in most product markets. In fact, millions of joint purchases occur because the potential search costs for the second good or service often exceed the potential savings for the customer from splitting the joint purchase into separate transactions. The joint purchase made by the customer entirely voluntarily in his best interest cannot be considered a tied sale. It is also quite clear that a supplier may explicitly demand that anyone buying a product or service also purchase another service as a condition of supplying the first one. This latter type of coercive tying is illegal under Section 106 of the Bank Holding Company Act, and has not been made an issue by SIA (F. 105).

Between the two extremes of explicitly coercive tied sales and purely voluntary joint purchases, a wide variety of tied sales may occur. They may range from a situation that is characterized by strong "implicit" pressure by the supplier on the customer to make the tied purchase, to a mere suggestion of the seller to the buyer that it might be to his advantage to make the joint purchase. The degree to which these pressures are exerted successfully, or are correctly perceived by the buyer, depends importantly on the market power of the supplier. "[T]he dangers of 'voluntary' tie-ins and reciprocity are basically structural." Conference Report, 1970 U.S. Code, Cong. & Adm. News at p. 5569, cited in *Ala. Ass'n. of Ins. Agents v. Board of Governors of the Federal Reserve System,* 533 F.2d 224, 250 (5th Cir. 1976). Whenever an appreciable degree of implicit pressure exists, a joint purchase is no longer purely voluntary because a consumer's decision is influenced or constrained to some extent by the presence of market power in the tying market. On the other hand, a consumer may choose to buy more than one product or service from the same source on the assumption that as a regular customer he will receive a more personal service or some benefit in the future. To force the purchaser to choose their second best alternative would deprive the public of their maximum satisfaction and potential search savings (F. 106).

Recent developments in financial services have significantly eroded the uniqueness of the products that commercial banks can offer so that banking concentration does not fully reflect the alternative sources available to the public for all the different banking services in a local market. Many alternative bank and non-bank sources of credit exist for locally limited customers (small businesses and consumers) that few borrowers could objectively conclude that any potential coercion or potential retribution exists if the two purchases are made separately. In competitive markets it is far more likely that borrowers judge the joint purchase to be both more convenient

and more economical, resulting in some cases in a high proportion of joint purchases.

An important objective of the Bank's marketing program is the cross selling of its services to present and prospective Schwab customers. BAC, in fact, anticipates that it will gain a substantial number of Schwab customers as Bank customers (*see* F. 103, 108, 122). Cross selling is beneficial to consumers because it (1) lowers consumer search costs; (2) lowers the cost (and thus the price) of goods and services as a result of efficiencies of joint production and sale, and (3) increases the value of goods and services as a result of economies of joint purchase and consumption. BAC and its subsidiaries attempt to find cross selling opportunities as a way of lowering their costs and increasing the value of the services they provide. Securities brokerage firms, particularly full-line brokerage firms, also engage extensively in cross selling. They regard it as important to offer their customers a variety of financial services and products, including those of their affiliates which offer opportunities for cross selling (F. 110). To the extent that BAC's acquisition of Schwab results in cross selling packages of financial services to Schwab and Bank customers, the result will be added competition and convenience for customers.

SIA acknowledges that Schwab's customers are "upscale retail banking customers," knowledgeable about their investments (SIA Proposed Findings 311, 95). Under the circumstances, these individuals are less likely to be implicitly coerced into purchasing a product or service not independently desired. While there is a possibility that some purchases will be made that are not truly voluntary, the benefits gained by eleminating [sic] those few transactions would be at the expense of the substantial number of truly joint purchases made on the basis of cost savings and convenience, real or imagined. Thus, the dangers of potential tie-ins have not been shown to outweigh the public benefits from cross selling.

G. *Conflicts of Interest, Public Confusion, and Risks of Schwab's Brokerage Business*

1. *Conflicts of Interest*

SIA contends that BAC's interest in maximizing the profitability of the company's subsidiaries as a whole may result in pressure being applied to the banking affiliate to take into consideration the interests of the larger unity when considering a loan application. When a loan applicant is a customer or potential customer of an affiliated subsidiary, the parent will have an interest in insuring that the customer obtains the loan in order to retain or increase the business of the affiliate and maximize the profitability of the company's subsidiaries as a whole. This could result in a conflict of interest in underwriting the loan application since a bank owes a duty to its depositors to evaluate a loan application soley on the basis of whether the loan would provide an adequate rate of return in light of the repayment risk. (SIA Proposed Findings 345-347).

A further conflict may arise in BAC's selection of a broker for its fiduciary trust accounts. BAC will have an incentive to process its trust department securities transactions through Schwab (SIA Proposed Findings 348-353).

Schwab performs brokerage services of a type which the Bank uses as a fiduciary of trust accounts. The fiduciary duty owed the Bank's trust account customers and BAC's economic interest in using Schwab to process the trust account orders also constitutes a potential conflict of interest resulting from the acquisition.

Soundness of bank practices is a primary purpose of regulatory supervision of banks, and the loans made by the Bank are subject to periodic review by federal examiners. The Bank employs strict internal standards and safeguards to prevent unsound loans. Federal laws and regulations impose a duty on the Bank to choose brokerage services upon the basis of "best execution." Trust departments are closely examined by federal regulators and Schwab, in addition, is regulated by the rules

and regulations of the SEC and the various exchanges (*see* 12 U.S.C. §§ 371(c), 375(b), and 12 CFR § 9.5). In addition, the Bank would be subject to suit for failure of its fiduciary responsibilities. BAC has established procedures for its trust department to insure that it fulfills its fiduciary responsibilities. There is no record evidence that BAC has, or will, engage in conflicts of interest that will cause undue consumer harm or injure competition.

Members of SIA (including their affiliates) sometimes have multiple interests in dealing with a customer. To the extent that such multiple interests give rise to potential conflicts of interests, these customers are protected both by law and by internal controls of these firms. SIA members regard applicable legal requirements as sufficient to protect their customers' interests. There is no evidence that the acquisition of Schwab by BAC would give rise to any conflicts of interest different in character or magnitude from those which broker/dealers and their affiliates experience.

2. *Public Confusion*

SIA argues that the marketing plans which BAC proposes to use with its Schwab affiliates, such as the logo "A BankAmerica Financial Services Company," the establishment of a division of Schwab called "Bank Brokerage Services," the placement of Schwab kiosks in Bank branches, and allowing Bank customers to use a Bank checking or savings account as a payment mechanism for a Schwab brokerage account, will lead customers to believe that BAC's and the Bank's financial resources stand behind Schwab in some manner. According to an expert witness for SIA, customers will believe that the Bank's financial resources stand behind Schwab in some manner and not appreciate that "BankAmerica" refers to the holding company and not the Bank (Mendelson Direct at 9-10; Mendelson Tr. at 1094). Presumably this public perception is not in accordance with the facts (SIA Proposed Findings 354-364).

BAC's present marketing plans for Schwab do not misrepresent any aspect of Schwab's affiliation with BAC or the Bank. Under the kiosk project the service will be identified to customers as "Stock Brokerage Services . . . Provided by Charles Schwab & Co., Inc." Customers wishing to place orders will deal directly with Schwab (McLin Rebuttal at 2-4). While the precise liability of the Bank for the obligations of Schwab may not be fully comprehended by customers (although the Schwab customer base consists of "Upscale" retail banking customers who have average incomes of about $60,000 per year—SIA Proposed Finding 311, and are knowledgeable concerning their investment alternatives—SIA Proposed Finding 95), Schwab actually will be in a stronger financial and management position after its acquisition by BAC than before the acquisition (F. 77, 78, 80).

While SIA has not made clear which members of the public will be harmed, the Bank's customers or Schwab's customers, all such customer accounts are subject to governmental regulation and are insured. Thus, there is little liklihood [sic] that public confusion about the nature of the relationship between the Bank and Schwab will occur, or that any limited confusion on the part of the public will cause any undue harm.

3. *Risks of Schwab's Brokerage Business*

SIA states that the brokerage industry is a high-risk industry subject to substantial and unpredictable fluctuations, and that discount brokerage is particularly subject to high risks because of large swings in the volume of securities trading and the relative rigidity of costs. The association together of Schwab and the Bank in the public's mind would cause a public loss of confidence in the Bank if Schwab failed as a business enterprise. Thus, the Bank would have an incentive to shore up Schwab through unsound loans or other measures inconsistent with sound banking practices to the detriment of Bank depositors (SIA Proposed Findings 365-380).

While the record establishes that the earnings of discount brokers has widely fluctuated, the brokers have been profitable (SIA Proposed Finding 367; Mendelson Direct at 12; BAC Exh. 19 at 9; F. 30, 31). Further, Schwab has been quite profitable (F. 11), and does not deal in or underwrite securities, the higher risk activities of brokers. It taxes credulity to assert that Schwab is likely to suffer, or BAC permit Schwab to sustain, financial reverses of such a magnitude that the Bank or its depositors would be jeopardized.

H. *De Novo Entry Should Not Be Required*

SIA contends that *de novo* entry by BAC would be more procompetitive than the acquisition of Schwab, and should be required if BAC desires to enter the brokerage industry (SIA Proposed Findings 381-387; SIA Reply Brief at 43-45). BAC unquestionably has the financial resources and technical experience to expand it [sic] present brokerage activities *de novo,* and such entry would not eliminate Schwab as an independent competitor, but would add a new competitor. *De novo* entry by BAC would also eliminate any additional profits BAC might make from cross selling Schwab customers, and the possible enhancement of Bank deposits.

Congress has provided in Section 4(c)(8), that:

> "In orders and regulations under this subsection, the Board may differentiate between activities commenced *de novo* and activities commenced by the acquisition, in whole or in part, of a going concern." 12 U.S.C. § 1843(c)(8) (1976).

"[W]here a bank holding company enters a new market *de novo,* or through acquisition of a small firm, as opposed to acquisition of a substantial competitor, its desire to succeed in its new endeavor is more likely to be competitive." H.R. Rep. No. 91-1747, 91st Cong., 2d Sess. 17-18 (1980) (conference report); *Ala. Ass'n. of Ins. Agents v. Board of Governors of the Federal Reserve System,* 533 F.2d 244, 249 (5th Cir. 1976).

While Congress clearly believed that an activity commenced *de novo* is likely to be more competitive than the acquisition of a substantial competitor, there is nothing in the legislative history, or in court or Board decisions, that mandates *de novo* entry by bank holding companies into new activities. Clearly, each proposed acquisition must be evaluated on its own under the statutory net "public benefits" and "adverse consequences" test. If a proposed acquisition passes the statutory test, the Board is authorized to approve it even though *de novo* entry might be more competitive.

Twelve U.S.C. § 1843(c)(8) indicates a wide range of factors to be considered by the Board when reviewing a non-bank acquisition. Unlike the provision governing Board approval of bank acquisitions, the statute does not articulate a specific antitrust standard for the Board to observe, although the statute does make adverse competitive effects a major consideration in connection with non-bank acquisitions. Whatever the exact contours of the balancing to be done, it appears that the Board would be constrained to disapprove an acquisition that would violate the antitrust laws. *See Whitney Nat'l Bank v. Bank of New Orleans,* 379 U.S. 411, 419 (1965). Further, it seems reasonable for the Board generally to be guided by antitrust principles in evaluating the competitive effects of any merger or acquisition. *Cf. County National Bancorp. v. Board of Governors of the Federal Reserve System,* 654 F.2d 1253 (8th Cir. 1981); *Mercantile Texas Corp. v. Board of Governors of the Federal Reserve System,* 638 F.2d 1255 (5th Cir. 1981). Thus, general antitrust principles developed for sound merger analysis are helpful to a focused and coherent inquiry into the potential competitive effects of BAC's proposed acquisition of Schwab.

An antitrust analysis first requires identification of relevant product and geographic markets. Definition of a relevant product market involves a determination of which product offerings are reasonably interchangeable as a matter of practi-

cal function and use[24] with the product provided by Schwab—retail securities brokerage. Two products should be placed in the same product market if commercial realities indicate that they present consumers with reasonably substitutable choices.[25] This test leads to the conclusion that the relevant product market is all securities brokerage provided to retail customers.

There is no apparent dispute that execution of securities trades on a stock exchange or in the over-the-counter market is a unique product. The only real product definition question raised in this proceeding is whether "discount brokerage" is a separate market from "full-line" brokerage services (*see* SIA Opposition Memorandum [May 28, 1982] at 27; *cf.* Mussa Tr. 888).

There is great variation among brokerage firms in terms of price structure and the range of services offered to customers. Some discounters offer investment advice and investment opportunities in addition to basic execution services, while many full-line firms offer discounts in order to retain large, active retail customers. However, "discount brokerage" does not define a discrete product market; it merely describes an important competitive response by a number of firms in offering the basic retail brokerage product. Discount brokers are simply those firms that advertise and charge commissions to all their customers which are substantially lower than the commissions in effect before May 1975 (when competitive pricing of retail commissions was first permitted).

Discount brokers and full commission brokers compete for the same transaction execution business of the same retail customers. Discount brokers choose to emphasize price while

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24 United States v. E.I. duPont de Nemours & Co, [sic] 351 U.S. 377, 395 (1956); *see* Department of Justice Merger Guidelines, par. II. A, (June 14, 1982 ("Merger Guidelines").[sic]

25 United States v. Aluminum Co. of America, 377 U.S. 271, 273-77 (1964).

full-line firms generally emphasize personal service. Discounts vary by both full-service and discount brokers, depending upon the type of customer and volume of trade (F. 26-29). The services offered by full-line brokers and discount brokers are reasonable supply substitutes.

Consumers also view the services offered by full-line and discount brokers as substitutes, a fact illustrated by evidence of record. Statistics show that many of Schwab's new customers are gained at the expense of full-line brokers while Schwab also lost many customers to these other brokers (Stupski Direct at ¶ 44; Biller Direct at 45). Indeed, even SIA's witnesses agreed that the basic service every broker provides is execution of the consumer's securities trades (Jannotta Rebuttal at 11). "[T]here are substantial similarities between what Schwab does and what national full line retail firms do." *Id.* at 3-4; Mussa Rebuttal at 17; Mussa Cross at 857. Dr. Mussa, SIA's expert economist, conceded that the relevant product market was all retail securities brokerage. Mussa Cross at 888; *accord.*, Baxter Cross at 437-38.

Further, discount brokerage does not constitute a submarket under the criteria for determining the existence of submarkets, enumerated by the Supreme Court in *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962). The product, discount brokerage, has no peculiar characteristics and uses, no unique production facilities, no distinct customers, no distinct prices, or sensitivity to price changes. It is debatable whether there are specialized vendors or industry recognition of discount brokers as a separate economic unit.[26] There is no clear, distinct separation between full-line brokers and discount brokers; the products and services they offer are interchangeable to a substantial degree.

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26 The SEC, in developing industry statistics, lists discount brokers with New York Stock Exchange, regional exchanges, introducing and carrying broker/dealer groups (BAC Exh. 55 at 33).

The proper geographic market in which to measure competition in retail securities brokerage is the entire United States (F. 25). The starting point is where Schwab in fact does business. Schwab's home base is in California, and it has a nationwide network of 51 offices in 26 states and the District of Columbia. While the bulk of Schwab's business comes from the metropolitan areas in which it has offices, it regularly deals with customers outside those areas. Schwab is licensed to conduct business in all fifty states. Its network of offices can be accessed by customers from anywhere in the United States through use of a toll free number (Stupski Direct at ¶¶ 4, 5)—Schwab has 80 toll-free numbers. Indeed, during certain hours Schwab's telephone network automatically switches customer calls between offices[27] with no apparent adverse effect on customer services.

In addition, Schwab, like other securities brokers, offers uniform rates throughout the country and it advertises primarily through nationwide financial publications (Stupski Direct at ¶ 5). Schwab's market is national in scope.

Dr. Baxter, a BAC witness, testified that given the ease of entry by out of area firms into markets and the ease of telephone access to out of area firms, securities brokerage firms compete in a national market (Baxter Cross at 440; *see also* Mussa Tr at 890-91). Thus, the evidence of record supports the conclusion that the market for retail brokerage services is national in scope.

The parties agree that the securities brokerage market is competitive (*see, e.g.*, Mussa Rebuttal at 6, 11-12; Biller Direct at 40; Baxter Direct at 28; F. 25, 26; SIA Proposed Finding 64). Concentration levels are quite low (Mussa Rebuttal at 5-7);

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27 For example, after 5 p.m. eastern standard time a New York City customer might well have his call switched to an open Schwab office in California, where his order would be taken and processed just as though it had been taken by the New York City office. *See* BAC Exh. Stupski—1 at 6.

four-firm concentration level in 1980 was 24% and eight-firm level was 37% (F. 24), and entry into the market is easy (Mussa Rebuttal at 8-9; SIA Proposed Findings 67, 81, 89). Furthermore, in terms of total commission revenues, Schwab's market share is less than one percent. By any conventional analysis, BAC's proposed acquisition of Schwab would not diminish competition in the competitive securities brokerage market.

SIA suggests that BAC is a "potential entrant" into retail brokerage and therefore should be compelled to enter *de novo* rather than by acquisition (Mussa Rebuttal at 45-51 [sic]); SIA Proposed Findings 381-387; SIA Reply Brief 43-45). Substantial concentration of the target market is a critical element that must be established to show that a proposed acquisition would eliminate significant potential competition.[28] This critical element is not present here since the brokerage market is unconcentrated. Moreover, Schwab has a very small share of that market. In addition, there appear to be numerous potential entrants into the brokerage market in the form of banks and savings and loan associations. Elimination of one potential entrant would hardly be significant.

Thus, there is no substantial evidence to support a claim that the proposed acquisition is likely to have a significant adverse effect on overall competition in the securities brokerage market. In fact, the acquisition by a potential entrant of a firm with one percent of the market could be considered a toe-hold acquisition having significant procompetitive effects.

V. *SIA's Requested Restrictions on BAC's Activities*

SIA has made a number of suggestions as to possible restrictions or conditions on BAC's activities (SIA Brief at 118-121). After due consideration it is concluded that none of these restraints should be enforced.

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28 *See, e.g.*, United States v. Marine Bancorporation, 418 U.S. 602, 624-25 (1974); Merger Guidelines, par. IV. A. 3. a.

The restriction considered and the reason for the rejection are:

1. BAC should not be allowed to use its assets or business relationship to finance Schwab's securities activities. As noted earlier in this decision, BAC's financial assistance to Schwab will not provide Schwab unfair competitive advantage vis-a-vis other securities firms. Any possible lowering of the cost of funds to Schwab would be an added benefit to the public. Congress has chosen Section 23A of the Federal Reserve Act, 12 U.S.C. § 371c, to regulate financial transactions between banks and nonbank affiliates. No showing has been made that additional safeguards are needed in the instant matter. Further, the Board has repeatedly enunciated the policy and managerial strength for its subsidiaries. *Citicorp. Fidelity Savings and Loan Ass'n.* ____ Fed. Res. Bull. ____ (Press Release dated September 28, 1982).

2. BAC should be prohibited from promoting Schwab as its affiliate causing (confusion to the public as to Schwab's separate corporate status) [sic]. BAC should not be permitted to promote Schwab on the basis of its affiliation with BAC or the Bank, and Schwab should not be permitted to share space with any member of the BAC organization (e.g., Schwab kiosks in Bank branches). As noted earlier, one of the real advantages to allowing the acquisition is the linking of Schwab, a very young, not well-established discount brokerage firm to a well-established bank. BAC will aid in the legitimazation [sic] of discount brokeraging to the benefit of small investors who might otherwise continue to use full-line brokers (*see Citicorp, supra.*)

3. Prohibit Schwab's providing of brokerage services for Bank fiduciary accounts. As noted, no sound reason

for insisting upon this restriction has been advanced since the Bank is already under regulatory and legal obligations with respect to its fiduciary accounts to act only in their best interests. Such a restriction might inhibit certain conveniences, efficiencies and cost savings.

4. Terminate the sale of municipal bonds through the "Munimart" program. As concluded herein, the Munimart arrangement merely presents an opportunity for the Bank to sell some municipal securities to Schwab customers that it might not otherwise sell. Schwab does not receive a better price from the Bank than other broker/dealers. Any real advantage to the Bank was granted by Congress through the Internal Revenue Code. For these reasons, any restrictions placed upon the Munimart program will have no real effect on the Bank's preferred tax status or municipal bonds and will restrain competition in the sale of such securities.

5. Permanently enjoin Schwab from offering investment advice. Schwab does not now nor does it or BAC have plans of offering investment advice to customers in the future (McLin Direct at 9-10). BAC's Application does not request permission to offer investment advice. Therefore, any restriction of such an activity is presently irrelevant.

6. Reasonably prohibit Schwab from underwriting or dealer activity, including the activities presently carried on with the Kemper market fund. It has already been found that the limited underwriting activities carried on by Schwab are a proper incident to its brokerage business, closely related to banking and are to be permitted.

7. BAC should not be permitted to expand its activities by the acquisition of other discount brokerage firms.

Any such acquisition would require Board approval and therefore any discussion of the subject at this time is totally unnecessary and premature.

8. Non-disclosed activities should be disallowed. For the reasons mentioned above any restrictions on activities not presently under consideration would be irrelevant to this decision.

9. BAC should be prohibited from continuing to offer Schwab products and services that are unnecessary to the operation of retail agency brokerage. SIA argues that activities like the offering of "sweep" accounts, and margin lending are unnecessary and unrelated to the proposed brokerage activities. It has been determined herein that such activities are permissable [sic] because they are closely related to banking and/or properly incidental to activities and reasonably necessary to effective carrying on of brokerage activities.

Accordingly, it is recommended that no restrictions be placed upon any of the activities of Schwab for which BAC is seeking Board approval.

SUMMARY

The Glass-Steagall Act, which restricts commercial bank involvement in investment banking, does not prohibit BAC from engaging in brokerage activities through its proposed acquisition of Schwab. The discount brokerage activities in which BAC will participate through its new acquisition, are closely related to banking within the meaning of Section 4(c)(8) of the Bank Holding Company Act, or are incidental activities reasonably necessary to carrying out the closely related activities. Benefits to the public far outweigh any possible adverse consequences that reasonably may be expected. These advantages include increased price competition in securities broker-

age and increased price and service competition in the larger financial services market. Also, increased efficiencies and greater convenience for individual customers can be expected. The restrictions proposed by SIA are to be denied; they are unnecessary, burdensome and would tend to negate the advantages that will otherwise arise out of the acquisition.

RECOMMENDATION

It is recommended that the application by BankAmerica Corporation to acquire The Charles Schwab Corporation and thereby engage in securities brokerage activities be approved.

ERNEST G. BARNES
Ernest G. Barnes
Administrative Law Judge

November 12, 1982

Errata to Recommended Decision of Administrative Law Judge, dated November 12, 1982

UNITED STATES OF AMERICA
BEFORE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM

DOCKET NO. R-0398

In the Matter of

Application by BankAmerica Corporation

To Acquire

The Charles Schwab Corporation

ERRATA

The following corrections should be made to the Recommended Decision filed herein today:

(1) Take out the second comma in the next to last [sixth] line on page 108 [84A].

(2) Change the last two [three] lines [of the third paragraph] on page 128 [97A] to read: "(4-firm concentration =66%) and 76% of all domestic loans (4-firm concentration =68%) in California banks."

(3) Change "if" to "is" in last [second] line [of the third paragraph] on page 131 [99A].

(4) Change the last sentence of paragraph numbered 1 on page 161 [119A] to read: "Further, the Board has repeatedly enunciated the policy that a holding company should serve as a source of financial and managerial strength for its subsidiaries."

Errata to Recommended Decision

(5) Change the first sentence of paragraph numbered 2 on page 161 [119A] to read: "BAC should be prohibited from promoting Schwab as its affiliate (causing confusion to the public as to Schwab's separate corporate status)."

ERNEST G. BARNES
Ernest G. Barnes
Administrative Law Judge

November 12, 1982

THE FEDERAL RESERVE SYSTEM

BankAmerica Corporation

Order Approving Acquisition of Retail Discount Brokerage Firm

BankAmerica Corporation, San Francisco, California ("BAC"), a bank holding company within the meaning of the Bank Holding Company Act (the "BHC Act"), has applied for the Board's approval under section 4(c)(8) of the Act (12 U.S.C. § 1843(c)(8)) and section 225.4(b)(2) of the Board's Regulation Y (12 C.F.R. § 225.4(b)(2)) to acquire 100 percent of the voting shares of The Charles Schwab Corporation, San Francisco, California, a company that engages, through its wholly-owned subsidiary, Charles Schwab & Co., Inc. ("Schwab"), in retail discount securities brokerage, extending margin loans, and other incidental activities. None of the proposed activities is among those that the Board has designated in Regulation Y as being closely related to banking and thus permissible for bank holding companies under section 4(c)(8) of the Act.

Notice of the application, affording interested parties an opportunity to submit comments and views, was duly published in the *Federal Register*. In response to its request for comments on this application, the Board received 17 written comments opposing the acquisition, and 82 favoring the acquisition, including comments from the Department of Justice, the Comptroller of the Currency, and the Securities and Exchange Commission. Among the comments opposing the proposal were those of the Securities Industry Association (the "SIA"), a national trade association representing over 540 securities brokers, dealers, and investment banking organizations. The SIA requested that the Board either deny, or order a formal hearing on, BAC's application.

On July 6, 1982, the Board issued an order scheduling a formal public administrative hearing on BAC's proposal. The

Board's hearing order observed that, while the questions raised by the various comments and protests to BAC's application might appropriately be resolved through additional written submissions, a formal hearing would provide an appropriate and expeditious method for developing a full record for Board consideration of any disputed material facts. The Board's order established an expedited briefing and hearing schedule. With the consent of the parties to the hearing, the United States Department of Justice was permitted to intervene as a party by order dated August 20, 1982.

A formal public administrative hearing, conducted in accordance with the Board's Rules of Practice for Hearings (12 C.F.R. Part 263), was held on September 8, 9, 10, 14, 15, and 16, 1982, in Washington, D.C., before an Administrative Law Judge appointed at the request of the Board. A substantial record on the application was developed through the submission of exhibits and testimony and through the participation of the SIA, BAC, the Department of Justice, and other interested parties.

In a Recommended Decision dated November 12, 1982, Administrative Law Judge Ernest G. Barnes concluded, based upon the evidence of record, that BAC's application met the criteria of section 4(c)(8) of the Act and, accordingly, recommended that the Board approve the application without condition. The SIA and BAC timely filed exceptions to the Administrative Law Judge's Recommended Decision.

Having carefully considered the entire record of the proceeding, including the comments received, and the transcript, exhibits, written testimony, rulings, and briefs filed in connection with the hearing, the Recommended Decision filed by the Administrative Law Judge, together with the exceptions thereto, the Board has determined that the Administrative Law Judge's findings of fact, conclusions, and recommendations, as modified and supplemented herein, are fully supported by the evidence of record and should be adopted as the findings and conclusions of the Board.

BAC, with total consolidated assets of $120.5 billion is one of the two largest banking organizations in the United States.[1] BAC operates one subsidiary bank, Bank of America N.T. & S.A., San Francisco, California ("Bank"). Bank, with domestic deposits of $51.9 billion,[2] is the largest commercial bank in the United States. BAC also operates numerous nonbanking subsidiaries located throughout the United States and abroad, including subsidiaries engaged in consumer and commercial lending, mortgage banking, leasing, data processing, investment advisory services, and certain credit-related insurance underwriting and insurance agency activities in California.

Schwab is a retail discount securities brokerage firm headquartered in San Francisco, California. Schwab operates 51 offices in 26 states and the District of Columbia, and has recently opened an additional office in Hong Kong. Schwab is a member of, and maintains seats on, various national and regional securities exchanges, including the New York Stock Exchange, the Chicago Board Options Exchange, and the Pacific Stock Exchange, and is registered with the Securities and Exchange Commission pursuant to section 15 of the Securities Exchange Act of 1934. Schwab buys and sells securities solely as agent, on the order and for the account of customers. Schwab does not purchase or sell securities for its own account except to an insignificant extent, does not engage in dealing or underwriting, and gives no investment advice. Schwab characterizes itself as a "discount" broker because its commissions are significantly lower than those charged by full-time brokers. In addition to brokerage services, full-line brokers offer investment advice. A Schwab customer is not assigned a personal representative but deals with any available representative, who in many cases enters the customer's order in an automated execution system, which can execute the order in as short a time as thirty seconds.

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1 Asset data are as of September 30, 1982.

2 Deposit data are as of December 31, 1981.

Schwab also extends credit for the purchase and carrying of securities and provides securities custodial services and various other services related to maintaining customer accounts, such as individual retirement accounts, a "sweep" arrangement with an unaffiliated money market mutual fund, payment of interest on net free balances awaiting investment, and third party payment services.

Schwab's Activities Are Closely Related to Banking

Section 4(c)(8) of the BHC Act permits a bank holding company to engage, directly or through a subsidiary, in activities that the Board, after due notice and opportunity for a hearing, has determined by order or regulation to be "so closely related to banking . . . as to be a proper incident thereto." The statutory standard requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must determine that the activity is, as a general matter, "closely related to banking." Second, the Board must find in a particular case that the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits that outweigh possible adverse effects.

Based on guidelines established in *National Courier Association* v. *Board of Governors*,[3] a particular activity may be found to meet the "closely related to banking" test if it is demonstrated that (1) banks generally have in fact provided the proposed activity; (2) banks generally provide services that are operationally or functionally so similar to the proposed activity so as to equip them particularly well to provide the proposed activity; or (3) that banks generally provide services that are so integrally related to the proposed activity as to require their provision in a specialized form. However, the *National Courier* guidelines are not the exclusive basis for finding a close relationship between a proposed activity and banking.[4]

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3 516 F.2d 1229, 1237 (D.C. Cir. 1975).

4 *Id.*

A. *Retail Securities Brokerage*

The undisputed facts of record demonstrate that many banks currently offer certain types of securities brokerage services. Many banks provide informal brokerage services, in which, as an accommodation to their customers, banks transmit customer orders to buy or sell securities selected by their customers to brokers for execution. In addition, banks, through the trading desks of their trust departments, routinely buy and sell securities as agent for trusts and other accounts managed by banks.[5]

As the SIA points out, Schwab's activities differ somewhat from the brokerage functions usually performed by banks: Schwab executes orders for the purchase or sale of securities directly, without the assistance of an intervening broker; and executes directly on the exchange orders involving securities listed on such exchanges. The Board finds, however, that Schwab's brokerage services are operationally and functionally very similar to the types of brokerage services that are generally provided by banks and that banking organizations are particularly well equipped to provide such services.[6]

The record shows that, as part of their current services, banks often execute orders involving securities not listed on an exchange by dealing directly with dealers making a market in the particular security or with other third parties. In performing these services, banks exercise the same type of discretion and judgment with respect to the best method of execution that brokers do with respect to similar types of orders. Moreover, many banks use a number of brokers to execute orders placed

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5 Banks also administer employee stock purchase, dividend reinvestment, and automatic investment service plans, which involve the periodic purchase of a particular security or securities from a fixed list of securities, on behalf of a customer.

6 The Board has found that the execution of unsolicited orders to buy or sell securities primarily of Israeli corporations solely as agent of the customer by a company that is not a member of a securities exchange is closely related to banking. *JCT Trust Company, Ltd.*, 67 Federal Reserve Bulletin 635 (1981).

with the bank by its customers or trust department. The record shows that in selecting a particular broker to execute a given order (especially in the case of orders for a block of securities), these banks make the decision themselves as to the best method of execution, leaving to the broker only the technical execution of the transaction. The Securities and Exchange Commission's 1977 report on bank securities activities found that bank trust department trading desks, at least at the largest banks, perform the same functions, utilize the same execution techniques, employ personnel with the same general training and expertise, and use the same facilities, *e.g.*, the consolidated tape, Quotron, AutEx, and other market information services, that brokers do.

In addition, national banks are expressly authorized by statute to purchase and sell securities without recourse, solely upon the order, and for the account of, customers. 12 U.S.C. § 24 Seventh. This authority supports the conclusion that Schwab's brokerage activities, which are within the plain meaning of the language of this authorization, are closely related to banking.[7]

Although the record indicates that in 1977 generally only the largest banks employed sophisticated securities trading procedures and resources, the record also shows that the technological changes in the securities markets and other developments have forced bank securities traders in large banks to develop and expand their skills and that this trend is expected to continue.[8] The Board finds that the use of sophisticated tech-

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7 The SIA asserts that this statutory authorization is limited to providing accommodation brokerage services to existing customers of the bank. Even if this assertion were correct, the fact that an activity is not permitted to a bank does not preclude a finding that the activity is *closely related* to banking and thus permissible for a bank holding company. *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46, 64 (1981).

8 Schwab also maintains customers' accounts and clears and settles executed transactions. Banks perform these functions in connection with the buy or sell orders banks effect for trust departments and as an accommodation to their customers. In addition, as a retail broker,

niques, resources and personnel to execute orders for the purchase or sale of securities for the account of customers is sufficiently widespread in the banking industry to justify a finding that banks generally provide securities execution services that equip them to offer the type of retail brokerage services provided by Schwab. Moreover, the Board finds that execution "in the crowd" on an exchange[9] is a largely ministerial function that involves no greater expertise or resources than the execution of orders directly with third party market makers, which banks generally now perform.[10]

The conclusion that Schwab's brokerage activities are closely related to banking is also consistent with the purposes of the BHC Act, which mandates the separation of banking from commerce in order to guard against the potential concentration of financial resources, conflicts of interest in the control of credit, and risks to insured depository institutions that are likely to result from the control by banking organizations of commercial enterprises. The laws restricting bank involvement in the investment banking business generally, while expressly recognizing that banks have been historically involved in some

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Schwab deals directly with the public to a far greater extent than the typical bank that offers securities brokerage services. However, the Board concludes that the degree of contact with the public does not substantially alter the type of expertise and judgment necessary to perform execution services, which in the case of both Schwab and banks generally is substantially the same.

9 Exchange members that are specialists in particular securities may exercise significant discretion and judgment with respect to trading in those securities. Specialists, however, trade for their own account. Schwab does not buy or sell securities for its own account and is not, therefore, a specialist on any exchange.

10 The fact that in many cases banks rely on brokers to execute customer orders placed with the bank does not preclude a finding that banks are well equipped to execute these orders directly, since the record shows that to a significant extent banks do effect buy and sell orders directly without the intervention of a broker or employ the broker merely to carry out the decision as to the method of execution made by the bank.

types of securities activities, are also designed to avoid conflicts of interest and risks to the safety of depository institutions.

B. *Margin Lending*

Schwab also engages in the extension of margin credit to Schwab's brokerage customers for the purchase and carrying of securities. Banks generally and traditionally have extended credit to their customers for the purpose of buying and carrying securities. At the end of 1981, banks had outstanding approximately $5 billion in loans to borrowers other than securities firms or financial institutions for the purpose of purchasing or carrying securities. In addition, the extension of credit secured by stock and other collateral has long been an important bank activity. The Board's margin credit regulations apply both to brokers such as Schwab (Regulation T) and to banks (Regulation U).[11] While Regulations T and U impose somewhat different requirements, the underlying margin credit activity engaged in by both banks and brokers is functionally the same. The Board therefore concludes that Schwab's margin lending activity is closely related to banking.

C. *Maintenance of Customer Securities Accounts*

In connection with carrying accounts of its securities brokerage customers, Schwab offers various services to its brokerage customers. These services include: (1) Individual Retirement Accounts, for which an unaffiliated savings and loan association serves as trustee; (2) a "sweep" arrangement, pursuant to which idle customer balances exceeding a predetermined minimum are automatically invested in an unaffiliated money market mutual fund; (3) the payment of interest on net free balances awaiting investment; and (4) the "Schwab-One Account," which combines the payment of interest on free credit balances with customer access to such balances through a debit card and checking account offered under an arrangement with

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11 12 C.F.R. Parts 220, 221.

an unaffiliated commercial bank. These services are increasingly being offered by other brokerage firms. The Board finds that each of these services is identical, or functionally and operationally equivalent to, services generally offered by banks to customers directly or through banks' trust departments. Accordingly, the Board finds, on the facts of this case, that BAC's provision through Schwab of IRA accounts, a money market sweep, and the "Schwab One Account" is closely related to banking as well as an incidental activity in connection with Schwab's securities brokerage and margin lending activities.

D. *Custodial Services*

Schwab also provides various types of securities custodial services, involving the safekeeping of customers' securities, accounting for dividends or interest received on such securities, and other ancillary services. Banks generally offer securities custodial services in connection with their trust department and other securities transaction services. In addition, in extending margin credit, a lender is required to maintain custody of the securities pledged to the lender as collateral to secure the loan. Accordingly, the Board finds that the provision of securities custodial services is closely related to banking and is a necessary incident to permissible margin lending activities.

"Proper Incident"—Net Public Benefits

With respect to the "proper incident" requirement, section 4(c)(8) of the Act requires the Board to consider whether the performance of the proposed nonbanking activity by an affiliate of a bank holding company "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." The Board finds that consummation of this proposal can reasonably be expected to result in public benefits outweighing possible adverse effects.

A. *Public Benefits Are Likely to Result from the Proposal*

1. *Increased Competition*

The record shows that the proposed acquisition is likely to make Schwab a more effective competitor in the retail brokerage market. It is likely that the proposal will strengthen Schwab as a competitor by affording Schwab greater acceptability by the public. The record indicates that discount brokers in general are hampered competitively, at least to some extent, because of a lack of public awareness and acceptance of their services due, in large part, to the relatively recent emergence of discount brokers and their lack of extensive office networks. Schwab's affiliation with BAC, a large, internationally recognized and diversified banking and financial services company with substantial resources, can reasonably be expected to result in enhanced public recognition and confidence in Schwab in particular, and discount brokers in general.

As a relatively new and small company, Schwab needs capital in order to expand its office network and facilities. It is undisputed that, because of its affiliation with BAC, Schwab expects to be able to obtain funds at a lower cost and more efficiently than at present.[12] The proposal is also likely to provide Schwab with access to BAC's managerial and technological resources, which, in view of BAC's size and expertise, are likely to assist Schwab in becoming a more effective competitor.[13]

Strengthening Schwab as a competitor is likely to have a procompetitive impact on price competition in the retail bro-

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12 The SIA's claim that Schwab currently has no difficulty in raising capital is immaterial (even if true), since an improvement in the cost and methods of raising funds is likely to produce an increase in Schwab's ability to compete for brokerage services. As explained below, the anticipated improvement in funding would not result in any unfair competitive advantage, because, among other things, BAC, not Bank, would provide funds to Schwab.

13 BAC has an extensive network of offices in this country and in many other countries and plans to assist Schwab in opening new offices.

kerage industry.[14] Since Schwab, like other discount brokers, competes primarily and aggressively on the basis of price, the strengthening of Schwab may induce full-line brokers to compete more vigorously for brokerage business on the basis of price. It is uncontested that the lower commission rates charged by discount brokers are taken into account by full-line brokers. The Recommended Decision forecast that this acquisition might produce a major change in the price structure of the brokerage industry by causing full-line brokers to "unbundle" their services. However, the evidence in the record is not substantial either in support of or against such a change. In any event, the acquisition is likely to have some procompetitive effect.

With respect to the likelihood of increased competition in the development of technology and in the provision of new combinations of financial services, the record indicates that Schwab has developed one of the most sophisticated automated order execution systems in the industry, which is important to Schwab's competitive efforts. Since this type of automated technology is rapidly developing and requires large financial resources to support such development, Schwab's access to BAC's funding support and technical resources can aid Schwab in continuing to offer efficient automated systems, which is likely to have a procompetitive effect throughout the industry.

2. *Increased Convenience and Efficiencies*

With respect to projected increases in convenience and efficiencies, the record shows that BAC will assist Schwab in adding new offices, some of which may be at locations where Bank has branches or where BAC's other nonbank subsidiaries have offices. While most of Schwab's brokerage business is done by telephone or mail, there is evidence in the record that some office locations are necessary to provide effective service.

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14 The SIA claims that there already is active price competition among retail brokerage firms. However, the fact that a market already is competitive does not preclude any further increase in competition.

Customers can make payments and deposit securities at Schwab offices without the inconvenience or cost of, or risk of nondelivery by, mail.

Moreover, the acquisition will permit Schwab and BAC to share their capital, managerial, technological, and marketing resources. In addition, by facilitating joint purchases or securities brokerage and other financial services, the acquisition can be expected to result in lower consumer search costs and greater efficiency in the purchase of such services.

In summary, the Board finds that this acquisition can reasonably be expected to result in some significant public benefits in the form of intensified competition, increased efficiency, and greater consumer convenience in the provision of retail securities brokerage services to the public.

B. *Lack of Significant Adverse Effects*

Having considered the facts of record and the allegations of all of the parties, the Board finds that the proposal is not likely to result in any significant adverse effects.

1. *Unlikelihood of Undue Concentration of Resources or Decreased Competition*

Assessment of the potential competitive impact of this proposal begins with a definition of the relevant product and geographic markets. The relevant product market includes all products that are reasonably interchangeable in practical function and use.[15] It is not disputed that retail securities brokerage constitutes a relevant product market. The SIA contends that discount securities brokerage is a relevant product submarket.[16] Based on the facts of record, the Board concludes

15 E.g., *United States* v. *E.I. duPont de Nemours & Co.*, 351 U.S. 377, 395 (1956).

16 The existence of a product submarket is determined by examining such practical indicia as industry or public recognition as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors. *Brown Shoe Co.* v. *United States*, 370 U.S. 294, 325 (1962).

that discount brokerage is not a sufficiently unique product to be considered a separate submarket. The record shows that some discount brokers offer investment advice in addition to the execution of buy and sell orders, while some full-line brokers offer discount brokerage services to large, active retail customers. According to the record, discount and full-line brokers are viewed by the public as reasonable substitutes, since many of Schwab's new customers are gained from full-line brokers, while Schwab has lost customers to full-line brokers.

The relevant geographic market is comprised of the market area in which the seller operates and to which the purchaser can practicably turn for supplies.[17] With 51 offices in 26 states and the District of Columbia, Schwab operates nationwide. Schwab is licensed to do business in all fifty states, has a uniform nationwide pricing policy, and advertises chiefly in nationwide financial publications. Customers can obtain access to Schwab's service from any place in the country by calling a toll-free telephone number. Based on this and the other evidence of record, the Board finds that the relevant geographic market for purposes of this proposal is the United States.[18]

The Board finds that this acquisition will not result in any significant reduction of competition or any increase in concentration of resources to an undue level in any relevant market. With respect to undue concentration of resources, while BAC has substantial assets ($112.9 billion in 1981), Schwab is not of significant asset size ($104 million). BAC's acquisition of

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17 *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 359 (1963).

18 The SIA claims that the State of California is the relevant geographic market on the theory that that area represents the area of competitive overlap between BAC and Schwab. This contention ignores the fact that Schwab and BAC each compete in different product markets. For similar reasons, the SIA's contentions regarding the inclusion of nonbank financial institutions in the banking product market are immaterial, since Schwab, the firm to be acquired, does not engage in banking activities.

Schwab (an increase of less than one per cent in BAC's assets) would not result in any unwarranted increase in the concentration of resources controlled by BAC.

The record indicates that Schwab's acquisition by BAC would not eliminate any significant existing competition in the nationwide retail brokerage market.[19] Schwab's share of the retail brokerage market, expressed in terms of a percentage of total commissions in that market, is less than one per cent. Bank's brokerage activities, primarily an accommodation for existing customers and employees, do not represent a significant market share.[20] While BAC may be viewed as a potential entrant into the retail securities brokerage market, that market is unconcentrated and characterized by low barriers to entry and numerous potential entrants.

The SIA notes that BAC anticipates an increase in Bank's deposits after the acquisition as a result of cross-selling Bank's services to Schwab's customers. While significant concentration exists in some local California banking markets and BAC's market share in those markets is significant, this acquisition will not directly cause any increase in Bank's deposits in any market. Such an increase, if it occurs, would result from success in cross-selling by BAC. In any event, the projected increase in Bank's deposits is of *de minimis* proportions.[21]

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19 Both Bank and Schwab engage in extending margin credit for the purchasing and carrying of securities. To the extent margin lending is a separate product, the proposal would not eliminate any significant competition. Neither Bank's nor Schwab's outstanding margin loans are substantial.

20 There is no substantial record evidence that the Board's conclusion concerning lack of elimination of potential competition would be altered even if discount brokerage were viewed as a product submarket. The record does not indicate that such a submarket is highly concentrated or that the number of potential entrants is low. Indeed, recent developments suggest that many banks must now be viewed as likely entrants into any such discount brokerage submarket.

21 It is not likely that BAC would gain significant competitive advantage from the projected growth in Bank's deposits since other large California banks, *i.e.*, Security Pacific National Bank and Crocker

The SIA contends that BAC's acquisition will eliminate competition in the brokerage product market by forcing other discount brokers either to become affiliated with a banking organization or be driven from the market. There is no evidentiary support for this allegation. However, even if the SIA's hypothesis is correct, it does not necessarily lead to the conclusion that competition will be diminished as a result. Indeed, such affiliations are likely to increase the vigor of competition. Moreover, the SIA does not contend that the acquisition will preclude any further entry into the retail brokerage market.

2. *Unlikelihood of Unfair Competitive Practices*

The SIA contends that, as a result of the acquisition, Schwab would have an unfair advantage over other brokers in the rates Schwab would pay for its funding. BAC plans to provide funding to Schwab by lending to Schwab the proceeds of funds raised directly by BAC. The SIA asserts that, because of explicit and implicit guarantees given by the federal government to the creditors of Bank (BAC's major asset),[22] BAC is able to raise funds at lower rates than brokerage firms that are not affiliated with a bank. According to the SIA, this alleged funding advantage is unfair because it rests on federal guarantees unavailable to brokerage firms not affiliated with banking organizations.[23] The SIA also argues that after the acquisition Schwab could obtain funds from BAC at rates lower than it currently pays and that this reduction in funding costs is not economically justified. The Board finds no significant adverse

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National Bank, have recently entered the retail brokerage field, and other banking organizations are also likely to enter.

22 Creditors of a bank holding company are not protected by federal deposit insurance. The SIA contends, however, that the government would come to the aid of any large bank in difficulty to maintain the stability of the financial system and that such assistance would benefit the parent holding company.

23 Brokerage firms benefit from a federal guaranty, *i.e.*, the Securities Investor Protection Corporation.

effects are likely to result from the proposed method of funding Schwab.

The record does not demonstrate that BAC's costs of funds are significantly lower than those of other corporations of similar resources. For example, the rates paid by BAC on its commercial paper during May through July 1982 were generally the same or higher than rates on commercial paper paid by corporations of similar size and credit ratings. Moreover, any cost advantage in raising funds enjoyed by BAC may be due to economic factors such as BAC's size, capital, and earnings, rather than to any guarantees applying to Bank alleged by SIA.[24] In any event, the Board finds that any advantage Schwab might obtain as the result of its borrowing from BAC is not unfair competition for purposes of section 4(c)(8). The legislative history of that section indicates that the term "unfair competition" was intended to refer to unfair or unethical business conduct (as defined by common law or under state or federal law), not disparities or advantages based on the structure and operations of the banking industry.[25] While the original 1956 BHC Act severely restricted borrowing by a bank holding company (or its nonbank subsidiaries) from its subsidiary bank,[26] Congress expressly declined to prohibit "downstream" financing, *i.e.*, borrowing by any subsidiary in the system from the parent. Congress found that downstream

24 BAC states that funds for Schwab would be provided by the parent holding company, not by Bank. Thus, any cost advantage Bank might enjoy because its deposit liabilities are federally insured is immaterial. In any event, it should be emphasized that the extent to which funds from Bank may be transferred to Schwab is strictly limited by section 23A of the Federal Reserve Act. 12 U.S.C. § 371c.

25 H.R. Rep. No. 1747, 91st Cong., 2d Sess. 18-19 (1970). The legislative history identified such practices as intimidation of customers and commercial espionage. *Id.*

26 70 Stat. 133, 137. These limitations were repealed in 1966 on the grounds that they were unnecessary in light of the similar, more flexible restrictions in section 23A of the Federal Reserve Act. 80 Stat. 236, 240; S. Rep. No. 1179, 89th Cong., 2d Sess. 10-11 (1966).

financing is a beneficial advantage of the bank holding company structure and permits the parent holding company to draw on its own capital and funds to strengthen the financial condition of its subsidiaries.[27] Recognizing this advantage, Congress authorized bank holding companies to acquire certain types of *nonbank* subsidiaries, which would compete against firms in the same line of commerce.

Moreover, the Board finds no basis in the SIA's claim that Schwab's ability to obtain low cost funding from BAC is economically unjustified. The Administrative Law Judge found, and the SIA does not contest, that the rate of interest BAC charges its subsidiaries on loans to such subsidiaries reasonably approximates BAC's own cost of funds. Moreover, the fact that the rates at which Schwab would be able to obtain funding might be lower than the rates at which other brokers pay does not *per se* demonstrate that the rates BAC charges Schwab are unfair or unjustified, since other economic factors not applicable to Schwab or BAC (*e.g.*, lower capital or earnings or lack of complete credit information) might justify higher rates paid by other brokers.[28]

The SIA also asserts that BAC intends to cross-sell banking services to Schwab customers, and thus has an incentive to subsidize Schwab's brokerage business. Cross-subsidization is an unfair competitive practice that occurs when the profits of one company are used to enable an affiliated company to offer its services at prices below its costs.[29] Cross-subsidization is successful, and therefore a likely practice, only where a company offering below-cost pricing has sufficient market domi-

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27 S. Rep. No. 1095, 84th Cong., 1st Sess. 15 (1955).

28 The Board does not accept the SIA's contention that BAC will lend funds to Schwab without regard to the risk involved. The record indicates that BAC does account for risk in determining the amount of funds to advance to a nonbank subsidiary and in determining whether an appropriate return will be earned on such advances.

29 *E.g.*, *Citicorp (Citishare)*, 68 Federal Reserve Bulletin 505, 512 (1982).

nance to be able to eliminate competitors by sustained below-cost pricing and thereafter to raise prices to recover the losses incurred through offering services below cost. It is clear from the record that Schwab does not have such a dominant position in the retail brokerage market and that the industry has very low barriers to entry. There is no evidence that BAC plans to offer brokerage services through Schwab at below Schwab's costs. The evidence shows that BAC expects Schwab to provide a positive return on equity.[30] The record evidence showing that BAC intends to cross-sell banking services to Schwab brokerage customers does not in itself demonstrate that BAC will cause Schwab to offer services at below cost.

Bank serves as a dealer in municipal securities. After the announcement of this proposal, BAC and Schwab entered into an arrangement under which Schwab provides its customers with information on municipal securities Bank holds in its inventory. The SIA contends that, since bank dealers in municipal securities enjoy more favorable tax treatment than nonbank dealers,[31] the arrangement between Schwab and Bank would permit Bank to exploit this allegedly "unfair" competitive advantage. However, the Board finds that any such competitive advantage results from the application of the federal tax laws, which affect all participants in the municipal securi-

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30 The SIA contends that BAC will have an incentive to subsidize Schwab's services because SIA expects that some Schwab customers will bring business to Bank and that Bank's earnings from this increased business will be greater than the losses caused by offering brokerage services at below cost. This contention, in the Board's view, is not based on any evidence in the record. The Board also notes that competition by financial institutions for deposits is strong, making it unlikely that Bank would be able to attain profit levels on deposits by customers of Schwab that would justify cross-subsidization. Moreover, in this connection, the Board notes that federal limitations on interest rates payable on deposits are being rapidly eliminated, resulting in increases in the cost of deposits.

31 The interest paid by nonbank dealers on funds borrowed to finance their inventory of municipal securities is not deductible for federal income tax purposes. 26 U.S.C. § 265(2). Bank dealers are exempt from this provision.

ties markets, and does not represent the type of adverse effect about which the BHC Act was concerned.

The Board further finds that the risk of voluntary tying of bank credit to use of Schwab's brokerage services is not substantial, given existing legal,[32] regulatory and internal BAC safeguards, and the record facts. Voluntary tying results when a customer believes that he or she stands a better chance of obtaining a scarce product by purchasing another product or service from the same seller. Where both products are in ample supply, voluntary tie-ins are not likely. These implicitly coerced joint sales are different from voluntary joint sales which, as the Administrative Law Judge found, can result in benefits to the customer by reducing search costs for the consumer and increasing efficiencies inherent in joint production and sale.

As the Board has previously found, the likelihood of voluntary tying depends on market structure and on the offering of a product that is relatively scarce.[33] The possibility of such tying is significantly reduced in competitive markets where there is a large number of alternative sources of the product involved (*e.g.*, credit). The Board finds that there are many alternative sources of credit (both bank and nonbank) available to the customers (mostly individuals) that are likely to use a discount broker like Schwab.

The SIA claims that because BAC intends to promote Schwab's services and because Bank's pricing of loans or other services, as a matter of policy, takes account of a customer's relationship with a nonbank subsidiary in the BAC system, there is the likelihood of implicitly coerced joint sales. The record shows that employees of Bank are expressly advised not

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32 Explicitly coerced joint sales are expressly prohibited by section 106 of the BHC Act Amendments of 1970, 12 U.S.C. §§ 1972-78, and are not an issue in this application.

33 *E.g., Citicorp (Person-to-Person Financial Center)*, 67 Federal Reserve Bulletin 443, 446 (1981). There is no evidence that brokerage services are such a scarce service that brokerage customers of Schwab will feel implicitly coerced into seeking deposit or credit services of Bank in order to continue to obtain brokerage services from Schwab.

to create even the impression that a customer might enhance the likelihood of obtaining a desired service by purchasing other products or services from Bank or its affiliates. Moreover, the record shows that customers of Bank that would be likely to use a discount broker are also likely to be (as are Schwab's current customers) relatively knowledgeable about financial matters. Such customers are less likely to be implicitly coerced into using brokerage services that are not independently desired. The Board does not believe the evidence suggests the likelihood of significant coerced joint sales.

3. *Unlikelihood of Other Adverse Effects*

The Board finds no persuasive evidence that BAC's acquisition of Schwab would result in significant conflicts of interest. The possibility that Bank might make unsound loans to Schwab customers to maximize Schwab's profits is not substantial and is neither based on evidence nor reasonable. Moreover, it would not be rational for Bank to place its own funds at risk in an unsound loan merely to increase brokerage commissions earned by Schwab. The Board finds no realistic basis for the SIA's contention that Schwab might "dump" worthless municipal securities on its customers as a result of its arrangement with Bank's municipal securities dealer operations. Under this arrangement Schwab identifies for its customers municipal securities held in Bank's inventory and does not give investment advice concerning the purchase or sale of the securities. There does not appear to be any substantive basis for any conflicts of interest arising from this procedure. Nor is there any credible evidence that Bank would breach its fiduciary duty by placing orders with Schwab for the purchase or sale of securities by Bank's trust department or customers where Schwab would not effect the best execution of the order.[34] There is no record evidence suggesting that Bank

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34 Bank's trust department is subject to a judicially enforceable duty to obtain best execution of orders under applicable statutes (15 U.S.C. § 78bb(e)(2)) and related regulations of its federal supervisor. 12 C.F.R. § 9.5, 47 Fed. Reg. 27831 (1982).

would use Schwab's services in situations that would result in a breach of fiduciary duty.

The earnings of discount brokers are heavily dependent on the volume of trading in securities and have fluctuated to a significant degree. However, the SIA's claim that Schwab is a high risk enterprise and that BAC might be compelled to make unsound loans to shore up Schwab is not supported by the record. Despite fluctuations in earnings, discount brokers in general, and Schwab in particular, have been profitable. Schwab's income has grown significantly in recent years. Schwab is not a speculative enterprise and the financial risks to BAC as a result of this proposal do not appear to be any greater than the risks involved in other permissible nonbank activities. The Board finds that it is unlikely that significant financial risks to BAC or Bank would result from the proposal.

The Board finds no basis for the SIA's contention that, because BAC intends to advertise its affiliation with Schwab, the proposed acquisition would result in public confusion. There is no evidence that BAC would misrepresent the nature of Schwab's affiliation with BAC or Bank, and BAC should assure that fully adequate disclosure of the status of Schwab obligations is made available to all customers.

The SIA further contends, without any evidentiary record for its claim, that Schwab solicits customers to place funds in Schwab's cash management account solely to earn interest and not for purchasing securities, that such funds might not be protected by Securities Investor Protection Corporation insurance (a protection that Schwab advertises), and that such an account constitutes the unlawful taking of deposits. The Board finds no basis for this allegation on the facts of this case. Guidelines issued by the Securities and Exchange Commission restrict registered brokers, such as Schwab, from soliciting funds solely to earn interest.[35] The rules of the New York Stock Exchange prohibit a member (such as Schwab) from paying interest on any free credit balance created for the purpose of

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35 3 Fed. Sec. L. Rep. (CCH) ¶ 25,134B.

receiving interest.[36] There is no evidence that Schwab will not comply with these limitations or that Schwab's advertising of SIPC insurance will be materially misleading.

In the exercise of its responsibility under the BHC Act, the Board has carefully considered whether BAC's financial and managerial resources are adequate to effect the proposed acquisition. In its evaluation of BAC's financial resources, the Board has reviewed all the relevant data concerning BAC's financial condition. Based upon this review, the Board concludes that the proposed acquisition would not represent a significant additional burden on BAC's financial resources. The Board notes the improvement in BAC's capital over the past year and expects that BAC will continue its efforts to improve its capital position. On balance, the Board concludes that BAC has both financial and managerial resources that are consistent with approval.

In sum, the Board finds that this acquisition may reasonably be expected to result in public benefits that outweigh possible adverse effects. Accordingly, since this acquisition satisfies both the "closely related" and the net public benefits tests of section 4(c)(8), the Board finds no basis for the SIA's contention that BAC must be required to enter the retail securities brokerage industry *de novo*.[37]

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36 *Id.*

37 The decisions cited by the SIA where the Board has denied the acquisition of a going concern by a bank holding company with the resources for *de novo* entry are inapposite. In those cases, the Board expressly found that acquisition of the going concern would eliminate substantial potential competition. *BTNB Corp.*, 58 Federal Reserve Bulletin 70, 71 (1972); *Marine Bancorporation*, 58 Federal Reserve Bulletin 504, 505 (1972); *Crocker National Corp.*, 58 Federal Reserve Bulletin 419, 420 (1972). Section 4(c)(8) does not require *de novo* entry by a bank holding company if, as here, the company's acquisition of a going concern will not substantially lessen competition and is likely to produce benefits that outweigh possible adverse effects.

The Acquisition Is Consistent with the Glass-Steagall Act

The SIA and various other commenters contend that the acquisition of a securities brokerage firm by a bank holding company is prohibited by provisions of the Glass-Steagall Act, the popular term for provisions of the Banking Act of 1933, that insulate commercial banking from certain aspects of the securities business. Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of any bank that is a member of the Federal Reserve System with any corporation or similar organization that is "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities.[38] For the reasons stated and upon the findings made in this Order, the Board concludes that Schwab is not engaged principally in any of the activities prohibited to member bank affiliates by the Glass-Steagall Act and accordingly concludes that this acquisition is consistent with the letter and spirit of that Act.

As a result of the consummation of this proposal, Bank, a member bank, would become affiliated with Schwab for purposes of section 20.[39] The SIA alleges that Schwab is engaged principally in the "public sale" of securities within the proscription of section 20 by virtue of its retail brokerage activities.[40] The Board finds, however, that the business of purchasing or selling securities upon the unsolicited order of, and as agent for, a particular customer does not constitute the

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38 Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 Seventh, provides that a national bank's dealing in securities and stock is limited to "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers" and not for the bank's own account, and that a national bank "shall not underwrite any issue of securities or stock." Section 21, U.S.C. § 378, prohibits any organization that receives deposits to engage at the same time "in the business of issuing, underwriting, selling, or distributing" securities.

39 12 U.S.C. § 221a(b)(2).

40 It is undisputed that Schwab's brokerage activities do not constitute the "issue, flotation, underwriting . . . or distribution" of securities.

"public sale" of securities for purposes of section 20. It is significant that, in describing proscribed activities of bank affiliates, section 20 does not mention "brokerage" activities, the generic term commonly associated with the business of buying and selling securities as agent for a customer.[41] In addition, in executing a customer's order to buy or sell securities, a broker does not make a public offer or hold itself out to the public as a seller or buyer for its own account but only acts as agent to assist the seller or buyer.[42] Furthermore, the terms "issue," "flotation," "underwriting," and "distribution" (used in section 20 in conjunction with "public sale") generally refer to the process by which new issues or large blocks or securities are distributed to the public, not to brokerage functions, which are primarily concerned with the transfer of securities at the request of a particular customer.[43] The term "public sale" used in association with this series of terms should be given a meaning similar to those terms since, under the rules of statutory construction, words grouped in a list should be given a related meaning.[44]

The view that "public sale" was not intended to apply to purchasing or selling securities as agent for a customer is further supported by the fact that the Board has consistently interpreted section 32 of the Glass-Steagall Act (12 U.S.C. § 78) as not applying to any brokerage activities. Section 32

41 2 L. Loss, *Securities Regulation* 1215 (2d ed. 1961). A securities *dealer* sells securities it has purchased for its own account elsewhere or purchases securities for its own account with a view toward selling them elsewhere. *Id.* A dealer ordinarily maintains an inventory of particular issues of securities and holds itself out to the public as being willing to purchase or sell such securities for its own account. A dealer is thus unlike a broker, which acts for the account of a customer.

42 *Cf.* Securities and Exchange Commission, Final Report on Bank Securities Activities 121-22, 167 (1977).

43 1 L. Loss, *supra* at 159-72.

44 *E.g.*, *Third National Bank in Nashville* v. *Impac, Ltd.*, 432 U.S. 312, 322 (1977).

prohibits managerial interlocks between a member bank and a firm primarily engaged in the same securities activities described in section 20. Beginning in 1936, the Board's Regulation R, which implements the provisions of section 32, has consistently provided that "[a] broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32."[45] Since section 20 and section 32 are part of the same statute and were enacted for the same purpose, the meaning of "public sale" as used in section 20 should be interpreted consistently with the same term in section 32.[46]

The SIA and other commenters contend that Schwab's retail brokerage activities are prohibited to banks under section 16 of the Glass-Steagall Act and thus should not be permitted to affiliates of banks. However, as the Supreme Court has made clear, section 20 determines the permissible securities activities of an affiliate of a bank and the fact that a bank might be precluded from engaging in a particular securities activity does not necessarily mean that a bank holding company is precluded from performing such service.[47] Moreover, section 16 *authorizes* national banks to engage in retail brokerage, *i.e.*, to

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45 22 Federal Reserve Bulletin 51 (1936), *codified at* 12 C.F.R. § 218.1 n.1.

46 The Board's view that brokerage activities do not constitute the public sale of securities was implicitly upheld by the Supreme Court in *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947). In *Agnew*, the Court affirmed a Board order finding that a particular securities firm with significant income from both underwriting activities and brokerage activities was "primarily" engaged in underwriting securities and thus covered by section 32. 329 U.S. at 445-46. The Supreme Court affirmed the Board's finding that the firm was primarily engaged in underwriting even though the amount of underwriting done by the firm did not exceed 50 per cent of its business. *Id.* at 447-49. The Court left undisturbed the Board's implicit finding that the brokerage business was not part of the business described in section 32.

47 *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46, 63-64 (1981).

engage in "purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers." 12 U.S.C. § 24 Seventh.

The SIA concedes that section 16 expressly authorizes some securities brokerage activities for banks, but contends, based on early interpretations of section 16 by the Comptroller of the Currency, that national banks are limited to executing orders without profit and only as an accommodation to existing customers, and that Schwab's services, not tied to the customers of any bank, clearly exceed these limitations.[48] However, beginning in 1957, the Comptroller has gradually departed from these early interpretations on the grounds that they are not supported by the express language of the statute, reflected an overcautious approach to bank regulation in the aftermath of the Great Depression, and are erroneous. Indeed, the Comptroller has recently authorized a national bank to establish a subsidiary to engage in discount brokerage services substantially the same as those provided by Schwab[49] and has advised the Board, in comments on BAC's proposal, that a national bank's purchase and sale of securities as agent is permissible under the Glass-Steagall Act.[50] In any event, inde-

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48 *See, e.g.*, 20 Federal Reserve Bulletin 609 (1934).

49 Comptroller of the Currency, Decision on the Application by Security Pacific National Bank to Establish an Operating Subsidiary To Be Known as Security Pacific Discount Brokerage Services, Inc. (August 26, 1982). The SIA is seeking judicial review of this decision. Among other things, the SIA has alleged that the establishment by a national bank of brokerage offices at locations where the bank is not permitted to branch violates the National Bank Act. The Board finds that there would be no violation of the federal branching laws in this application under the BHC Act, since Schwab is a separate corporation, has its own capital and officers and directors, and would not be operated in a unitary fashion with Bank, but as a nonbank subsidiary of a bank holding company. *See Grandview Bank & Trust Co.* v. *Board of Governors*, 550 F.2d 415 (8th Cir.), *cert. denied*, 434 U.S. 821 (1977).

50 The SIA argues that Schwab's activities do not meet the "without recourse" requirements of section 16, since in many cases Schwab executes transactions directly without the assistance of an intervening

pendent of the validity of the Comptroller's constructions of section 16, the Board finds that Schwab's brokerage functions do not constitute the "public sale" of securities (or any other proscribed activity) within the meaning of section 20 of the Glass-Steagall Act, the applicable statutory provision.[51]

This conclusion is consistent with the purposes of the Glass-Steagall Act. During congressional consideration of the Glass-Steagall legislation, the scope of permissible bank brokerage activity was not discussed in detail.[52] However, since the types of bank securities activities considered harmful and contrary to public policy were exhaustively catalogued in the legislative history and brokerage activities received no serious attention, it is unlikely that Congress viewed such activities as the target of the Act's prohibitions.[53] Indeed, the particular type of securi-

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broker against whom Schwab's customers might otherwise have recourse for any alleged fraud or negligence. However, in the Board's view, the ordinary commercial meaning of "without recourse" indicates that section 16 prohibits a bank from assuming the liability of endorser or maker with respect to the securities bought or sold as agent of the customer. *See* G. Munn & F. Garcia, Encyclopedia of Banking & Finance 943 (7th ed. 1973; U.C.C. § 3-414(1)). There is no evidence that Schwab would assume any such liability.

51 The SIA further asserts that "public sale" in section 20 must be interpreted similarly to the terms "purchasing and selling" as used in sections 16 and 21, which, the SIA contends, clearly include brokerage functions. However, section 16 expressly permits purchasing and selling securities for the account of customers.

52 The relevant legislative history merely states that national banks would be permitted to buy and sell securities for their customers to the same extent as heretobefore. S. Rep. No. 77, 73rd Cong., 1st Sess. 16 (1933).

53 The SIA's reliance on various statements by a draftsman of the Securities Exchange Act of 1934 is without merit. These statements were made after enactment of the Glass-Steagall legislation, are not the views of a member of the legislature, and do not purport to deal with the outer limits of permissible bank brokerage activities. In addition, the Comptroller of the Currency's explanation of the 1935 amendment to section 16 (which merely clarified that the scope of permissible

ties activities engaged in by Schwab are fully consistent with the objectives of the Glass-Steagall Act. As has been widely recognized, the Glass-Steagall legislation was intended to eliminate the risk of loss or insolvency that may result when a bank purchases securities for resale to the public, makes unsound loans to bolster its marketing of particular securities, or loses public confidence when it becomes apparent that the bank has a "salesman's stake" in the success of a particular investment opportunity.[54] Further, as noted above, the Board believes that Schwab's activities pose no greater risk of failure than other nonbanking activities permitted by the Board to bank holding companies. The Board finds that these types of hazards are not present in connection with Schwab's activities, since, except on very infrequent occasions, Schwab does not purchase or sell securities as a principal, *i.e.*, with its own assets.[55] Nor does Schwab have any interest in the success or failure of any particular issue of securities, since its operations are limited to

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brokerage included execution of orders for stock as well as for debt securities) appears merely to be a statement of the Comptroller's now-rejected administrative interpretation of the 1933 legislation.

54 *E.g.*, *Board of Governors* v. *Investment Company Institute*, *supra*, 450 U.S. at 61-62; *Investment Company Institute* v. *Camp*, 401 U.S. 617, 629-34, 635-38 (1971). The SIA's reliance on the Supreme Court's passing remark in the second *ICI* decision that the ACT was intended to divorce banks from underwriters and brokerage houses, 450 U.S. at 63, is misplaced. Brokerage activities were clearly not at issue in that case. Also, most brokerage firms also engage in dealing in securities, an activity that *is* generally impermissible under the Act. *See* 2 L. Loss, *supra* at 1215.

55 Schwab acts as a principal if it mistakenly purchases securities not authorized by the customer. Such "inadvertent principal" transactions are less than one per cent of Schwab's business and clearly not a principal activity. In addition, in infrequent cases, Schwab may purchase municipal securities in a new issue as riskless principal—with its own assets but only after a firm customer order for such securities has been received. These riskless principal transactions (also not a principal activity of Schwab) appear to be consistent with permissible brokerage activities, and, in any event, section 16 expressly authorizes banks to act as principal with respect to certain types of municipal securities.

providing a service enabling investors to purchase or sell expeditiously securities selected by the customer. Although, as the SIA points out, unsuccessful operations by an affiliate may well damage the reputation of a bank or bank holding company, the Board finds that the likelihood of harm to the reputation of BAC or Bank as a result of this proposal is minimal, since Schwab does not actively promote any particular securities and does not offer investment advice.

Schwab also offers to its customers a "sweep" arrangement, under which idle customer balances awaiting investment and exceeding a predetermined amount are routinely and automatically used to purchase shares of an unaffiliated money market mutual fund. The Board has pending before it a separate petition submitted by the SIA alleging that such "sweep" arrangements by banks constitute the impermissible underwriting of the securities of the money market mutual fund and believes that this issue is more appropriately resolved in that context. Even if it is assumed that Schwab's sweep arrangement constitutes underwriting of the money fund's securities, the record clearly shows that Schwab is not principally engaged in that activity. Thus, no violation of section 20 would arise as the result of the present application.

Proposed Restrictions on Schwab's Activities

The SIA asserts that, if the Board determines to approve the proposal, various restrictions should be imposed to address the alleged adverse effects of the acquisition by limiting Schwab's activities solely to securities brokerage, by restricting the method by which Schwab obtains funds, establishes offices, advertises its affiliation with BAC, and by prohibiting Bank from using Schwab to execute transactions for Bank's fiduciary accounts or to sell municipal securities. For the reasons explained above, the Board concludes that significant adverse effects are not likely to result from the proposal and, accordingly, the Board finds that the imposition of the restrictions advanced by the SIA is not warranted. Because BAC's plans to finance and promote Schwab and to place Schwab offices at

some BAC locations are not likely to produce any unfair competitive advantage, public confusion, or other adverse effects, the Board finds no basis to restrict such activities. Also, Bank's use of Schwab to buy or sell securities as agent for the Bank's trust department or to transmit information on Bank's municipal securities inventory should not be prohibited, since these operations present the prospect of no serious adverse effects.[56]

In approving BAC's application to acquire Schwab, the Board grants approval under the BHC Act only for those activities considered by the Board.[57] Thus, any change or expansion in the activities described in this Order would require the approval of the Board.

Consistency with Objectives of the BHC Act

The Board has reviewed this application from the viewpoint of its basic consistency with the objectives of the BHC Act. This Act was designed to eliminate the potential for conflicts of interest and concentration of resources that are inherent in the commingling of banking and commerce to help maintain banks as impartial providers of credit, to avoid the anticompetitive effects that would inevitably arise from close links between the control and use of credit, and to protect the banking system and ultimately the economy as a whole from the instability that could result from bank participation in commerce. The Board believes that these fundamental considerations retain their essential validity and should continue to guide the evolution of banking services in the changing economic and competitive environment that we have today.

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56 Indeed, a complete prohibition against Bank's use of Schwab's brokerage service could conceivably cause a breach of fiduciary duty in a particular case where Schwab in fact can provide the best execution of the order. Moreover, there is no indication that Schwab will not comply with the limitations that the SEC and other authorities have prescribed on the receipt by brokers of funds solely to earn interest. A similar Board-imposed limitation is unnecessary.

57 12 C.F.R. § 225.4(c)(2).

The Board finds that there is no inconsistency between the basic policies of the BHC Act and the conduct of the nonbanking activity that is the subject of this application. As described in detail in this Order, the Board has found that a securities brokerage service that is essentially confined to the purchase and sale of securities for the account of third parties, and without the provision of investment advice to the purchaser or seller, does not raise the potential for conflicts of interest or concentration of resources that were the object of the prohibitions that were instituted to assure the separation of banking from commerce. Expansion of banking into securities activities must proceed carefully, but the proposed activity raises none of the concern that engenders the need for restrictions on banking or bank holding company activities.

Based upon the foregoing and other considerations reflected in the record, the Board has determined that the public benefits associated with consummation of this proposal can reasonably be expected to outweigh possible adverse effects, and that the balance of the public interest factors, which the Board is required to consider under section 4(c)(8) of the Act, is favorable. Accordingly, the application is hereby approved.

This determination is subject to the conditions set forth in section 225.4(c) of Regulation Y and the Board's authority to require such modification or termination of the activities of a holding company or any of its subsidiaries as the Board finds necessary to assure compliance with the provisions and purposes of the Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.

Because of the extensive consideration accorded to Schwab's securities brokerage, margin lending, and incidental activities in the context of this application, and having determined that the public interest considerations of section 4(c)(8) favor approval of BAC's proposal, the Board has determined that further applications by BAC to extend Schwab's retail discount securities brokerage, margin lending, and incidental activities to additional offices may be processed in the same manner as other *de novo* applications under the provisions of section 225.4(b)(1) of Regulation Y (12 C.F.R. § 225.4(b)(1)). Author-

ity is hereby delegated to the Federal Reserve Bank of San Francisco to take action on such notices properly filed as prescribed in that section.

The proposed activities shall not commence later than three months after the effective date of this Order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of San Francisco.

By order of the Board of Governors,[58] effective January 7, 1983.

(Signed) James McAfee

James McAfee
Associate Secretary of the Board

[SEAL]

58 Voting for this action: Chairman Volcker and Governors Martin, Wallich, Partee, Rice and Gramley. Absent and not voting: Governor Teeters.

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 83-4019

Argued: May 23, 1983

Decided: July 15, 1983
(as amended September 20, 1983)

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—against—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, et al.,

Respondents,

—and—

BANKAMERICA CORPORATION,

Intervenor.

Appearances

JAMES B. WEIDNER, ESQ., New York, N.Y. (Rogers & Wells, New York, N.Y., John M. Liftin, Esq., Harry M. Yohalem, Esq., David A. Schulz, Esq., Mark Holland, Esq., Bruce E. Braverman, Esq. and Donald J. Crawford, Esq., Washington, D.C., William J. Fitzpatrick, Esq., New York, N.Y., of counsel), for Petitioner Securities Industry Association.

GARY D. WILSON, ESQ., Washington, D.C. (Wilmer, Cutler & Pickering, Washington, D.C., Arnold M. Lerman, Esq., Alan S. Tenenbaum, Esq. and H. Helmut Loring, Esq., William S. MacKay, Esq., Janice Decker, Esq., San Francisco, California, of counsel), for Intervenor BankAmerica Corporation.

RICHARD M. ASHTON, Attorney, Board of Governors of the Federal Reserve System, Washington, D.C. (Michael Bradfield, General Counsel, Kevin J. Handly, Attorney, Board of Governors, Washington, D.C., and J. Paul McGrath, Assistant Attorney General, Civil Division, Department of Justice, Washington, D.C., of counsel), for Respondents Board of Governors of the Federal Reserve System.

ROBERT S. RIFKIND, ESQ., New York, N.Y. (Cravath, Swaine & Moore, New York, N.Y., Stephen S. Madsen, Esq. and Deborah S. Prutzman, Vice President and Counsel, The New York Clearing House Association, New York, N.Y., of counsel), for The New York Clearing House Association, Amicus Curiae.

Before:

FEINBERG, *Chief Judge*,
LUMBARD and WINTER, *Circuit Judges*.

LUMBARD, *Circuit Judge*:

On January 7, 1983 the Federal Reserve Board authorized the BankAmerica Corporation, a bank holding company, to acquire the Charles Schwab Corporation, the sole owner of Charles Schwab & Co., the nation's largest "discount" brokerage firm. The Securities Industry Association (SIA), a national trade association representing over 540 securities brokers,

dealers, and investment banking companies, petitions for judicial review of the Board's order. SIA contends that the acquisition approved by the Board violates both the Glass-Steagall Act and the Bank Holding Company Act. We find, however, that neither of those Acts prohibits a bank holding company from engaging in retail brokerage, and that the Board acted well within its discretion in approving BankAmerica's application. We therefore deny SIA's petition for review and affirm the order of the Board.

The BankAmerica Corporation (BAC), with total assets of $120.5 billion, is the second largest bank holding company in the United States. BAC's most important subsidiary is the Bank of America (Bank) which, with domestic deposits of $52 billion, is the nation's largest commercial bank. Charles Schwab & Co. (Schwab) is principally engaged in retail securities brokerage. Schwab buys and sells securities solely as agent, on the order and for the account of its customers. Schwab offers its brokerage customers incidental services including margin loans, securities custodial services, and "sweep" accounts in which net balances awaiting investment are deposited in a money market fund not affiliated with Schwab. Schwab does not, however, offer its customers investment advice and, with minor exceptions not here relevant, does not underwrite or deal in securities. Schwab and similar firms are called "discount brokers" because the commissions they charge typically are significantly lower than those charged by full-service brokerage firms which offer investment advice. Schwab, headquartered in San Francisco, operates nationwide with offices in 26 states and the District of Columbia. Although, by revenue, Schwab currently holds 9% of the discount brokerage market, it holds less than 1% of the total retail brokerage market.

On March 8, 1982 BAC applied to the Federal Reserve Board for permission to acquire 100% of the stock of Schwab's parent corporation. BAC filed its application under § 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(8) (1976), which authorizes the Board to approve a bank holding company's acquisition of a subsidiary if the subsidiary's activities are "closely related" to banking and if

the public benefits reasonably to be expected from the acquisition outweigh possible adverse effects. The Board published notice of BAC's application in the Federal Register, 47 Fed. Reg. 16,104 (1982), and requested comments from interested parties. The Antitrust Division of the Department of Justice, the Comptroller of the Currency, and the Securities and Exchange Commission all filed comments in support of the application. SIA opposed the application and requested the Board to conduct a formal hearing. An administrative law judge held an evidentiary hearing in September, 1982, and on November 12, 1982, issued his decision recommending that the acquisition be approved. The judge found the proposed acquisition to be consistent with both the Glass-Steagall Act and the Bank Holding Company Act. On January 7, 1983 the Board adopted the judge's findings and conclusions, with modifications, and authorized BAC to acquire Schwab. 69 Fed. Res. Bull. 105 (1983). SIA petitions for review under 12 U.S.C. § 1848 (1976).

I. *Glass-Steagall Act*

Those provisions of the Banking Act of 1933 that mandated a separation of the commercial and investment banking industries are known as the Glass-Steagall Act. *See* Pub. L. No. 73-66, §§ 16, 20, 21, & 32, 48 Stat. 162 (1933). SIA claims that the Glass-Steagall Act prohibits bank holding company subsidiaries from conducting a retail brokerage business. Although SIA's claim raises an issue of law which we have the ultimate responsibility to decide, *see* 5 U.S.C. § 706 (1976), the Board's thorough opinion rejecting the claim is entitled to substantial deference. Because the Board has both primary responsibility for implementing the Glass-Steagall Act and expert knowledge of commercial banking, we must uphold its interpretation of the Act if it is reasonable. *See Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 56 n.21 (1981), quoting *Board of Governors* v. *Agnew*, 329 U.S. 441, 450 (1947) (Rutledge, *J.*, concurring); *Investment Co. Inst.* v. *Camp*, 401 U.S. 617, 626-27 (1971); *A.G. Becker Inc.* v. *Board of Governors*, 693

F.2d 136, 140-41 (D.C. Cir. 1982). We conclude that the Board's interpretation was reasonable and entirely consistent with the Act's language and policy.

Only one of the Glass-Steagall Act's four provisions is directly applicable to bank holding companies. That provision, § 20, 12 U.S.C. § 377 (1976) states:

> [N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization *engaged principally in the issue, flotation, underwriting, public sale, or distribution* at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . .

(emphasis supplied). As a bank holding company's various subsidiaries are bank affiliates for purposes of § 20, *see* 12 U.S.C. § 221a(b) (1976), BAC's acquisition of Schwab will make Schwab an affiliate of Bank. Section 20 therefore prohibits the acquisition if Schwab is "engaged principally" in any of the activities listed in the statute. Although SIA concedes that Schwab is not engaged in the issue, flotation, underwriting, or distribution of securities, it argues that Schwab's retail brokerage business does constitute the "public sale" of securities.

SIA's interpretation of "public sale" to include brokerage is rebutted by the "familiar principle of statutory construction that words grouped in a list should be given related meaning." *Third Natl. Bank in Nashville* v. *Impac, Ltd.*, 432 U.S. 312, 322 (1977) (footnote omitted). *See also General Elec. Co.* v. *OSHA*, 583 F.2d 61, 65 (2d Cir. 1978). The terms "issue," "flotation," "underwriting," and "distribution" all refer to the widespread marketing of specific issues of new securities in which the dealer trades as principal for his own profit. *See generally* L. Loss, Securities Regulation 159-72 & 547-53 (2d ed. 1961). Such activities greatly differ from retail brokerage, in which the broker trades as an agent for commission, not as a principal for profit, and does not transfer title. Thus if "public sale" is to be given a meaning similar to that of the terms that surround it, it cannot be read to encompass retail brokerage.

Moreover, if Congress had intended § 20 to cover brokerage, it presumably would have used words more precise than "public sale." Section 16 of the Act, 12 U.S.C. § 24(7) (1976), authorizes banks to engage in "purchasing and selling . . . securities and stocks without recourse, solely upon the order, and for the account of, customers." Congress' use in § 16 of language that specifically refers to brokerage,[1] and its omission of similar terms from § 20, suggests that Congress did not intend § 20 to cover brokerage. *See FTC* v. *Sun Oil Co.*, 371 U.S. 505, 514-15 (1963) (terms carefully employed by Congress in one place, and excluded in another, should not be implied where excluded).

The Board's ruling that § 20 does not encompass brokerage is supported by its long-standing interpretation of a different provision of the Glass-Steagall Act, § 32, 12 U.S.C. § 78 (1976). Section 32 prohibits managerial or other interlocks between member banks and any entity primarily engaged in "the issue, flotation, underwriting, public sale, or distribution" of securities. Section 32's list of prohibited activities is precisely that found in § 20. In January, 1936, shortly after the Banking Act of 1935 revised § 32 into its present form, the Board ruled that "[a] broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32." 22 Fed. Res. Bull. 51 (1936). The Board's interpretation of § 32, to which it still adheres, *see* 12 C.F.R. § 218.1 n.1, has been confirmed by the Supreme Court. In *Board of Governors* v. *Agnew*, 329 U.S. 441 (1947), two directors of a national bank also worked for a securities firm which derived approximately 32% of its gross income from underwriting, and 42% from brokerage. The Board ruled that the directors' outside firm was "primarily engaged" in activities covered by § 32, and it ordered the directors to resign from the bank. The directors challenged the Board's order in court. The District of Columbia Court of Appeals, by a divided vote, held that an injunction should issue. 153 F.2d 785 (1946). The

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1 The scope of the brokerage activities which § 16 authorizes banks to conduct is open to debate. *See infra.*

majority and dissenting opinions in the Court of Appeals agreed that § 32 does not cover brokerage. 153 F.2d at 790, 795. They disagreed only on the degree of involvement necessary for a firm to be "primarily" engaged in an activity prohibited by § 32. The Supreme Court granted certiorari and reversed. The Court concluded, as had the dissenting judge in the Court of Appeals, that a firm is "primarily" engaged in a prohibited activity if it is "substantially" so engaged, and that the Board's order was therefore lawful notwithstanding the fact that the directors' outside firm earned less than half of its revenue from underwriting. Although the Court did not explicitly rule brokerage to be excluded from § 32, it did distinguish the firm's brokerage income from its underwriting income, and used the language of § 32 to define "underwriting" as the "issue, flotation, underwriting, public sale or distribution" of securities. 329 U.S. at 445 n.3. It thus seems clear that the Court read § 32 to exclude brokerage. Indeed, if the Court had not so read the statute, it would not have had to explore the meaning of "primarily engaged," since the directors' outside employer was, under any interpretation of the term, "primarily engaged" in underwriting and brokerage taken together. Use of the same language in different statutory provisions, where the various provisions were enacted together and concern the same general goals, is a strong indication that Congress intended the language to have the same meaning wherever it appears. *See Northcross* v. *Board of Educ. of the Memphis City Schools*, 412 U.S. 427, 428 (1973); *Hargrave* v. *Oki Nursery, Inc.*, 646 F.2d 716, 720 (2d Cir. 1981). The Board's consistent interpretation excluding brokerage from § 32 is thus, especially in view of *Agnew*, strong evidence that brokerage is excluded from § 20.[2]

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2 Also significant is the Supreme Court's comment in *Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 58 n.24 (1981), that § 20 prohibits bank ownership of securities affiliates that are engaged principally "in the issuance or underwriting of securities." The Court's failure to include "brokerage" in the list of activities covered by § 20 is a further suggestion that brokerage is excluded from the statute.

The policies behind the Glass-Steagall Act shed further light on the proper interpretation of § 20. Congress intended the Act to address two principal concerns. First and foremost, Congress believed that commercial bank involvement in underwriting and securities speculation had unduly placed bank assets at risk and had contributed to "the widespread bank closings that occurred during the Great Depression." *Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46, 61 (1981) (footnote omitted). Securities trading had impaired bank solvency not only directly through bad investments by banks, but also indirectly through the unsound banking practices that securities trading promoted. In particular, Congress recognized that a bank trading for its own account has a "salesman's interest" that is inconsistent with the traditional role of banks as impartial extenders of credit. A bank seeking to sell the stock of a particular company might, for example, extend customers credit to be used for purchase of the stock or might grant the company an unsound loan simply to improve the stock's marketability. *See Investment Co. Inst.* v. *Camp*, 401 U.S. 617, 631 (1971). Similarly, a bank that engages in trading through a securities affiliate might improperly extend credit to the affiliate, or to companies in which the affiliate invested, in order to avoid the loss in public confidence it would experience if the affiliate failed. Securities trading further shakes public confidence in banks because it associates banks with speculative ventures, and because some customers purchasing securities on bank representations will inevitably suffer losses. This loss of public confidence poses an additional threat to bank solvency. *See id.*, 401 U.S. at 631-32. Thus in strictly limiting the right of commercial banks to trade in securities, Congress sought to ensure bank solvency, to protect bank depositors, and to maintain public confidence in the nation's banks. Second, Congress recognized the inherent conflict between the promotional role of an investment banker and the commercial banker's obligation to give disinterested investment advice. A commercial bank that trades as a principal might allow its interest in trading profits to override the fiduciary duties owed to depositors. *See id.*, 401 U.S. at 633. Congress thus intended

the Glass-Steagall Act to guarantee that the impartiality of investment advice would not be "tainted by a desir · to profit from the promotion of one particular security over another." Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 Yale L.J. 102, 104 (1981) (footnote omitted).

Schwab's brokerage services do not present any of the dangers which the Glass-Steagall Act was designed to forestall. Because Schwab trades only as an agent, and never as a principal, its assets are not subject to the risks of the securities markets. Equally important, Schwab's lack of a "salesman's interest" in the securities it trades eliminates the incentive for the Bank to engage in promotional activities. Schwab's revenue depends solely on the volume of shares traded, and is not dependent upon the sale or purchase of specific securities. Thus the Bank cannot increase Schwab's profits by extending credit to securities issuers to bolster their stock or to purchasers for the purchase of specific shares, or by improperly favoring particular securities in its management of customers' assets. Although Schwab and the Bank will be associated with one another in the public eye, the losses that some customers will sustain on trades executed through Schwab will be unlikely to impair public confidence in the Bank. Given Schwab's strict policy not to offer investment advice, customers who trade unsuccessfully will have only themselves, and not Schwab or the Bank, to blame for their mistakes.

The Act's legislative history and Supreme Court precedent support our interpretation of the Act's focus. First, the legislative history, though it discusses at length the dangers posed by commercial bank involvement in underwriting and securities speculation, *see, e.g.*, S. Rep. No. 77, 73d Cong., 1st Sess. 8-10 (1933), makes but passing reference to bank brokerage activity. The Senate report states only that the Act allows banks to "purchase and sell investment securities for their customers to the same extent as heretofore." *Id.* at 16. This statement hardly suggests that brokerage was one of Congress' principal concerns. Second, in *Investment Co. Inst.* v. *Camp*, *supra*, the Supreme Court drew a clear distinction between brokerage and activities in which a bank trades as a principal. In *Camp*, the

Court held that a bank's plan to distribute shares in a bank-managed open-end investment fund would constitute an impermissible underwriting of securities in violation of § 16 of the Act. The Court emphasized that the bank would have a salesman's stake in the fund's shares, and thus would have an incentive to engage in promotional activities contrary to the Act's policy. The Court contrasted the bank's plan with brokerage services, and stated that the hazards associated with promotional activities "are not present when a bank undertakes to purchase stock for the account of its individual customers." 401 U.S. at 638. The Court stated that purchases on account "do not give rise to a promotional or salesman's stake in a particular investment; . . . do not entail a threat to public confidence in the bank itself; . . . and do not impair the bank's ability to give disinterested service as a fiduciary or managing agency." *Id.* The Court's comments, though dicta, strongly suggest that Congress did not intend § 20 to prohibit bank affiliates from engaging in retail brokerage. *See also New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091, 1099-1100 (D.D.C. 1975) (bank's plan to purchase securities on account for customers, and automatically to deduct designated purchase amount from customers' bank accounts, held to be consistent with the Act), *vacated on other grounds*, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

We thus find the Board's ruling to be supported by both the language of § 20 and the Act's policy. SIA argues, however, that § 20's true meaning cannot be found without reference to § 16 of the Act, 12 U.S.C. § 24(7) (1976), which defines the extent to which commercial banks may trade in securities. Section 16 states, in pertinent part, that:

> The business of dealing in securities and stock by [a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account.

Although SIA concedes, as indeed it must, that § 16 is directly applicable only to banks, and not to bank holding companies, *see Board of Governors* v. *Investment Co. Inst.*, 450 U.S. 46,

58 n.24 (1981), it argues that §§ 16 and 20 must be interpreted "consistently," and cannot be read to permit bank holding companies a broader degree of brokerage activity than is allowed to banks. SIA contends that § 16 does not authorize banks to conduct retail brokerage businesses such as Schwab's. SIA's position is supported by certain early rulings by the Comptroller of the Currency which held that § 16 authorizes a bank to engage in brokerage only if (1) the customer has a customer relationship with the bank independent of the brokerage transaction, (2) the bank offers its brokerage services at cost, and (3) the customer makes prior payment or has assets at the bank sufficient to cover his transaction. *See e.g.*, 1 Bulletin of the Comptroller of the Currency, No. 2 at 2-3 (1936). Relying principally upon the Comptroller's rulings, SIA argues that banks may engage in brokerage only to accommodate existing customers, and that the principal brokerage activities of bank holding companies must, under a consistent interpretation of the Act, be similarly limited.

The proper interpretation of § 16 is before us only incidentally, and we do not think it necessary to explore the question in detail. Instead, three considerations convince us that SIA's attempt to transfer the focus of this case from § 20 to § 16 is unavailing. First, the Comptroller of the Currency recently reversed the rulings upon which SIA relies. In *Security Pacific Natl. Bank*, [Current] Fed. Bank. L. Rep. ¶ 99,284 (CCH) (1982), the Comptroller held that § 16 authorized a national bank to establish a subsidiary that would offer discount brokerage services to the public but would not offer investment advice. The Comptroller stated that his earlier restrictive rulings reflected "the great caution of banking regulations in the years immediately following the 1931-32 debacle," and were not supported by either the purposes or the express language of the Glass-Steagall Act. Because we agree with the Comptroller that the Act's policies are not contravened by bank participation in retail brokerage, we are inclined to give significant weight to the Comptroller's repudiation of his earlier rulings.[3]

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3 SIA has brought an action in the District Court for the District of Columbia challenging the Comptroller's ruling in *Security Pacific*

Second, SIA has not convincingly explained why §§ 16 and 20, notwithstanding Congress' use of very different language in the two provisions, must be interpreted alike. If, as SIA contends, Congress intended in §§ 16 and 20 significantly and equivalently to restrict the brokerage activities of banks and bank holding companies, it presumably would have used the same, or at least similar, language in both statutes. Finally, the structure of the Act "reveals a congressional intent to treat banks separately from their affiliates," *Investment Co. Inst.*, *supra*, 450 U.S. at 59 n.24, and clearly indicates that the same prohibitions do not apply to both. Banks, for example, under § 16 can never underwrite or deal in the securities of private issuers, while bank holding companies, under § 20, can engage in such underwriting and dealing so long as they are not principally so engaged. SIA argues that this distinction between §§ 16 and 20 is unimportant; that the same *types* of activities are prohibited to banks and to bank holding companies; and that bank holding companies, even if they can partially engage in certain activities totally barred to banks, cannot principally engage in such activities. SIA thus concludes that § 20 at most authorizes Schwab minimally to engage in retail brokerage, and does not allow it to make brokerage a principal line of business. We think, however, that the latitude the Act grants bank holding companies partially to engage in activities such as underwriting, which implicate the Act's policies whether conducted by banks or by bank holding companies, suggests that bank holding companies can, under the Act, be allowed principally to engage in activities which pose the dangers the Act addressed only when conducted by banks. Congress clearly intended the Act to restore banking as the principal business of banks, and may have believed (though we see no support for the point in the legislative history) that banks would be unreasonably diverted from banking by participation in retail brokerage. But even if Congress, because of

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Natl. Bank. Securities Industry Assoc. v. *Conover*, No. 82-2865 (D.D.C. filed October 6, 1982). What we say here is not meant to express an opinion on the validity of the Comptroller's ruling.

such concerns, restricted in § 16 the brokerage activities allowed to banks, no similar danger of diversion is posed by the brokerage activities of bank holding companies. Thus even if § 16 prohibits banks from acting as retail brokers, we would have to conclude, in light of (1) the statutory language and policy considerations previously discussed and (2) the Act's clear intent to "treat banks separately from their affiliates," that Congress did not intend § 20 to prohibit bank holding companies from acquiring or establishing brokerage subsidiaries.[4]

II. *Bank Holding Company Act*

The Bank Holding Company Act, 12 U.S.C. §§ 1841 *et seq.* (1976), generally prohibits bank holding companies from engaging in nonbank activities. However, section 4(c)(8) of the Act, 12 U.S.C. § 1843(c)(8), provides that a bank holding company may acquire:

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4 SIA also argues that the Board's order contravenes the provision of § 16 that limits national banks to "purchasing and selling such securities and stock without recourse. . . ." SIA contends that Schwab trades "with recourse" because brokerage customers occasionally "walk away" from trades that prove unprofitable within the settlement period, leaving Schwab liable to the third party to the transaction for the purchase price or for delivery of the security. Beyond the fact that SIA has not convinced us to incorporate § 16's language into § 20, we do not think that Schwab's activities violate § 16 merely because it faces the kind of incidental liability to which SIA refers. The Supreme Court's decision in *Awotin* v. *Atlas Exchange Natl. Bank of Chicago*, 295 U.S. 209, 212 (1935) (holding that a repurchase agreement between the bank and one who bought bonds from it was void as a violation of § 16), strongly suggests that the limitation in § 16 is directed against endorsement or guaranty contracts "by which the bank assumes the risk of loss which would otherwise fall on the buyer of securities, or undertakes to insure to the seller the benefit of an increase in value of securities which would otherwise accrue to the Bank." Schwab does not enter into contracts that obligate it to "assume" ultimately its brokerage customers' risks; on the contrary, it retains full power to bring actions for breach of contract against customers who fail to pay for or deliver securities.

> shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Section 4(c)(8) further provides that:

> In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern.

Section 4(c)(8) authorizes the Board to approve a bank holding company's acquisition of a nonbank subsidiary only if it determines that (1) the subsidiary's activities are "closely related" to banking, and (2) the public benefits reasonably to be expected from the acquisition will outweigh possible adverse effects. *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess. (1970) *reprinted in* 1970 U.S. Code Cong. & Ad. News 5561, 5572-73. *See, e.g., Independent Ins. Agents of America, Inc.* v. *Board of Governors*, 658 F.2d 571, 573 (8th Cir. 1981); *Citicorp* v. *Board of Governors*, 589 F.2d 1182, 1190 (2d Cir.), *cert. denied*, 442 U.S. 929 (1979); *National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1232-33 & n.2 (D.C. Cir. 1975). SIA challenges the Board's ruling that BAC's acquisition of Schwab satisfies both of these requirements.

Section 4(c)(8) and its legislative history do not identify the factors the Board is to consider in determining which activities are closely related to banking. However, in *National Courier*

Assn., *supra*, 516 F.2d at 1237, the District of Columbia Court of Appeals held that the Board may treat any activity as one closely related to banking if there is present one or more of the following connections between the activity and the business of banking:

> 1. Banks generally have in fact provided the proposed services.
>
> 2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.
>
> 3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

Although the factors listed in *National Courier Assn.* do not exhaust the possible connections which could establish a close relationship between a proposed activity and banking, *see id.*, they do usefully elucidate the closely related standard and have been employed by several of the courts of appeals, *see NCNB Corp.* v. *Board of Governors*, 599 F.2d 609, 613 (4th Cir. 1979); *Association of Bank Travel Bureaus, Inc.* v. *Board of Governors*, 568 F.2d 549 (7th Cir. 1978); *Alabama Assn. of Ins. Agents* v. *Board of Governors*, 533 F.2d 224, 241 (5th Cir. 1976), and by the Board. *See, e.g.*, *Citicorp*, 68 Fed. Res. Bull. 505 (1982).

In this case the Board, relying upon the second of the *National Courier Assn.* factors, held that the present securities activities of banks are operationally or functionally so similar to brokerage that banks are particularly well equipped to act as retail brokers. The Board found that many banks, as an accommodation to their customers, transmit to brokers customer orders to buy or sell securities, and that the trading desks of bank trust departments routinely buy and sell securities as agents for trusts and other accounts. The Board noted one principal difference between the securities activities of brokerage houses and of banks: brokerage houses trade listed

securities directly on the exchanges, while banks historically have employed intervening brokers to execute such trades, but it concluded that banks nonetheless have expertise in the methods of securities trading. The Board found that banks, when trading unlisted securities, often deal directly with dealers or other third parties, and that such trades require banks to "exercise the same type of discretion and judgment with respect to the best method of execution that brokers do with respect to similar types of orders." The Board further found that when banks employ intervening brokers, they often direct the broker on the best method of execution, and leave to the broker only the technical execution of the transactions. Finding that banks widely buy and sell securities for the accounts of their customers, and have become skilled in securities trading, the Board held that retail brokerage is an activity closely related to banking.

The Board's factual findings are conclusive if supported by substantial evidence, 12 U.S.C. § 1848, and the Board's findings on bank trading activities are clearly so supported. SIA, however, argues that the Board misapprehended the legal standard implicit in the closely related test. SIA claims that an activity is closely related to banking only if it facilitates actual banking practices[5] and can be conducted by most of the

[5] As enacted in 1956, § 4(c)(8) (then § 4(c)(6)) authorized bank holding companies to engage in activities "of a financial, fiduciary, or insurance nature . . . which the Board . . . has determined to be so closely related to *the business of banking* . . . as to be a proper incident thereto." Pub. L. No. 511, § 4(c)(6), 70 Stat. 137 (1956). The Board interpreted the phrase, "the business of banking," to prohibit bank affiliation with any company whose activities were not directly related to the banking operations that the particular holding company was already engaged in. Congress in 1970 deleted the words "the business of" in order to make it clear that the acquired company's activities need not be closely related to the acquiring holding corporation's specific banking business, but only to banking generally. *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 5561, 5567; *National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1236 (D.C. Cir. 1975). SIA thus argues that § 4(c)(8) required the Board to find that retail brokerage facilitates banking generally, and does not argue that facilitation of BAC's particular banking operations is required.

nation's banks. SIA argues that brokerage does not satisfy either of those requirements, and is therefore not closely related to banking. We do not agree.

SIA's challenge to the Board's legal conclusion must be evaluated in light of the deference ordinarily due to Board determinations under § 4(c)(8). Congress has committed to the Board primary responsibility for the administration of the Act. The Board, moreover, has expertise in commercial bank regulation that the courts do not have, and it must be allowed reasonable latitude in its application of the Act to the changing activities of banks. For these reasons the Board's determination that brokerage is closely related to banking "is entitled to the greatest deference," *Investment Co. Inst., supra*, 450 U.S. at 56 (footnote omitted), and may be overturned only if unreasonable or inconsistent with Congressional intent. *See National Courier Assn.* v. *Board of Governors*, 516 F.2d 1229, 1237 (D.C. Cir. 1975). We see nothing in SIA's arguments that would justify reversal of the Board's order under this standard of review.

SIA's claim that an activity must facilitate actual banking practices to be closely related to banking is, we think, refuted by the Supreme Court's decision in *Investment Co. Inst., supra*. In *Investment Co. Inst.*, the Supreme Court upheld a Board regulation issued under § 4(c)(8) that authorized bank holding company subsidiaries to serve as investment advisers to closed-end investment companies. An investment company offers small investors portfolio diversification and expert management by pooling their resources under the guidance of one manager. Investment advisers are independent of the investment companies they advise. In return for a management fee, an investment adviser selects the investment company's portfolio and supervises most aspects of its business. In affirming the Board's determination that investment advisory services are closely related to banking, the Court emphasized that such services "are not significantly different from the traditional fiduciary functions of banks." 450 U.S. at 55. The Court stated that the principal duty of an investment adviser is to manage the investment portfolio of its client, and noted that

banks, in their roles as executors, trustees, and managing agents, have for decades provided equivalent management services to bank customers. *Id.* The Court's analysis thus focused upon the relationship of investment advisory services to services traditionally performed by banks. The Court upheld the Board's regulation because the proposed activity constituted, in effect, the provision in a nonbanking context of services that banks have traditionally offered their customers. The Court never considered whether investment advisory services provided to nonbank investment companies facilitate actual banking practices, and it seems quite clear that they do not. Thus both the result reached in *Investment Co. Inst.*, and the analysis the Court employed, indicate that an activity need not facilitate banking practices to be closely related to banking.

SIA also contends that an activity, to be closely related to banking, must be open to most banks. SIA argues that only the largest banks have the skills and resources needed to engage in retail brokerage; that banks *generally* will not be able to enter the brokerage business; and that brokerage is therefore not closely related to banking. SIA's argument ignores the Board's express finding "that the use of sophisticated techniques, resources and personnel to execute orders for the purchase or sale of securities for the account of customers is sufficiently widespread in the banking industry to justify a finding that banks generally provide securities execution services that equip them to offer the type of retail brokerage services provided by Schwab." In any event, even if the Board had found to the contrary, we could not accept SIA's conclusion. The closely related standard does not require proof that banks generally will be able to perform the proposed service, but instead principally concerns whether the proposed service is functionally related to the traditional services banks generally have performed. The interpretation SIA gives the Act would effectively preclude the nonbank affiliates of bank holding companies from providing financial services not open to the smallest banks. We see nothing in the legislative history to suggest that Congress intended the closely related standard so greatly to

restrict innovation in the financial industry. *Cf.* H.R. Conf. Rep. No. 1747, *supra*, 1970 U.S. Code Cong. & Ad. News at 5568 ("One of the asserted justifications for permitting bank holding companies to engage in activities that the Board has determined independently to be closely related to banking, is to permit the introduction of new innovative and competitive vigor into those markets which could benefit therefrom."). An inability of banks generally to engage in a proposed activity may, of course, raise questions of competitive effect or undue concentration of resources, but such questions are appropriately resolved under § 4(c)(8)'s public benefits test and not under the closely related standard.

Finally, SIA challenges the Board's determination that the public benefits reasonably to be expected from BAC's acquisition of Schwab will outweigh the possible adverse effects. We see no basis for disturbing the Board's conclusion. As the Fifth Circuit has recognized, *see Alabama Assn. of Ins. Agents*, *supra*, 533 F.2d at 246, Board determinations under the public benefits test necessarily involve some speculation, and should be upheld if reasonable. The Board's ruling here plainly is reasonable.[6] SIA further argues that the Board erred in failing

6 The Board found that a number of public benefits are likely to result from BAC's acquisition of Schwab. The Board found that the acquisition will strengthen Schwab as a competitor by affording it access to BAC's managerial, financial, and technical resources. Noting that Schwab competes primarily on the basis of price, the Board stated that the strengthening of Schwab could induce full-line brokers to engage in greater price competition. The Board found that Schwab's affiliation with BAC, a large, internationally-known financial services company, should increase public confidence in Schwab and in discount brokers generally. Because discount brokers have been hampered by a lack of public awareness and acceptance of their services, increased public confidence in discount brokers should enhance their ability to compete against better-known firms. Finally, the Board found that Schwab's affiliation with BAC will increase consumer convenience. For example, Schwab offices operated at branches of the Bank will reduce consumer search costs by enabling consumers to obtain a broader range of financial services at a single location than is now possible. The Board found that the acquisition is unlikely to have any significant adverse effects, such as undue concentration of resources, decreased competition, or unfair competitive practices.

to require de novo entry by BAC into the retail brokerage business. Section 4(c)(8) states that in orders under the statute "the Board *may* differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern." (emphasis supplied). Congress included this language in § 4(c)(8) because it believed that de novo entry generally has greater procompetitive effect than does entry through the acquisition of an existing competitor. *See* S. Rep. No. 1084, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Ad. News 5519, 5534; H.R. Conf. Rep. No. 1747, *supra*, 1970 U.S. Code Cong. & Ad. News at 5568. SIA argues that, because many of the benefits expected to result from BAC's acquisition of Schwab could equally be achieved through de novo entry by BAC into retail brokerage, the Board must require de novo entry. We do not agree. Congress did not favor de novo entry as a goal in itself, but as a means of maximizing the procompetitive effects of activities conducted under § 4(c)(8). Here, the Board found that BAC's acquisition of Schwab will not substantially lessen competition, and will likely produce public benefits that outweigh possible adverse effects. Where, as here, entry by acquisition promotes competition as effectively as would de novo entry, and involves no significant anticompetitive effects that de novo entry would avoid, the Board has discretion to permit entry by acquisition.

The petition for review is denied; the order of the Board is affirmed.

RELEVANT PROVISIONS OF THE BANKING ACT OF 1933 (THE GLASS-STEAGALL ACT)

SECTION 5(c):

12 U.S.C. § 335. Dealing in Investment Securities; Limitations and Conditions

State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph "Seventh" of section 24 of this title.

SECTION 16:

12 U.S.C. § 24. Corporate Powers of Associations

Upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

* * *

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency

may by regulation prescribe. . . . As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, co-partnership, association or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, or . . .

SECTION 20:

12 U.S.C. § 377. Affiliation with Organization Dealing in Securities; Penalties

After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

SECTION 21:

12 U.S.C. § 378. Dealers in Securities Engaging in Banking Business; Individuals or Associations Engaging in Banking Business; Examinations and Reports; Penalties

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities,

to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or state banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate;

* * *

SECTION 32:

12 U.S.C. § 78. Certain Persons Excluded from Serving as Officers, Directors or Employees of Member Banks

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

RELEVANT PROVISIONS OF THE BANK HOLDING COMPANY ACT

12 U.S.C. § 1843. Interests in Nonbanking Organizations

Ownership or control of voting shares of any company not a bank; engagement in activities other than banking.

(a) Except as otherwise provided in this Act no bank holding company shall—

(1) after the date of enactment of this Act [enacted May 9, 1956], acquire direct or indirect ownership or control of any voting shares of any company which is not a bank,

* * * * * *

(c) Exemptions. The prohibitions in this section shall not . . . apply to—

* * * * * *

(8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. In orders and regulations under this subsection, the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern;